No. 85-1877

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1985

AZL RESOURCES, INC.,

Petitioner,

v.

MARGARET HALL FOUNDATION, INC., *et al.*,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

ALVIN K. HELLERSTEIN
(Counsel of Record)
THOMAS FARBER
STROOCK & STROOCK & LAVAN
7 Hanover Square
New York, New York 10004
(212) 806-5400

and

JEROME GOTKIN
GORDON P. KATZ
WIDETT, SLATER & GOLDMAN, P.C.
60 State Street
Boston, Massachusetts 02109
(617) 227-7200

Question Presented

Does Section 20(a) of the Securities Exchange Act of 1934 determine the vicarious liability of a corporation for the alleged securities fraud of its chairman committed with apparent authority only and solely for his own personal gain, thereby making applicable to the corporation the defense of its good faith and its not having directly or indirectly induced the acts complained of, or do common law principles of vicarious and strict liability determine the liability of a corporation under such circumstances?

List of Parties

The parties to the proceedings below were petitioner AZL Resources, Inc. and the following respondents: Margaret Hall Foundation, Inc., Lexington Cemetery Co., Inc., Harley Anderson Haynes, Ruth Mann Horowitz, Robert L. Horowitz, as Trustee of The Alan J. Mann Trust, Susan P. Mann Trust and Gail A. Mann Trust, Walter B. Gates, George M. Berman and Alan R. Schoolman (as they comprise the Profit-Sharing Committee of The Unitrode Profit Sharing Plan and Profit Sharing Trust Fund), and Martin B. Hoffman (as trustee of Landlubber Deferred Profit Sharing Retirement Plan), individually and on behalf of all others similarly situated; Gerald J. Holton, individually and as employer and as beneficiary of his self-employed retirement plan and Plymouth-Home National Bank, as trustee of a Self-Employed Retirement Plan, Gerald J. Holton FBO Gerald J. Holton; Bruno Rossi; James P. Giblin, individually, and as Trustee of the James P. Giblin Trust; Benjamin Slomoff and Michael Holt Massey.

Rule 28.1 List

The parent company of AZL Resources, Inc. is Tosco Corporation. AZL has no subsidiaries other than wholly owned subsidiaries. The following companies are also subsidiaries of Tosco Corporation: Diablo Service Corporation, Lion Oil Trading Company, Ltd., Sand Wash Development Corporation, The Oil Shale Corporation, The Oil Shale Corporation (Australia), The Oil Shale Corporation (Qld.) Pty. Ltd., Tosco Communities Corporation, Tosco Development Corporation, Tosco Enhanced Oil Recovery Corporation, Toscogen, Inc. (formerly Lion Oil Company), Tosco International Corporation, Tosco International Energy Corporation, Tosco International Finance, N.V., Tosco Mining, Inc., Toscopetro Corporation, Tosco Production Finance Corporation, Tosco Services and Development, Inc., Tosco Trading, Transportation and Supply, Inc., ToscoTech Corporation, Western Hemisphere Corporation.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

The petitioner, AZL Resources, Inc. ("AZL"), respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the First Circuit, entered in the within proceeding on February 19, 1986.

Opinions Below

The opinion of the Court of Appeals for the First Circuit has not yet been reported. It is reprinted in the appendix hereto, App. A, *infra*, 2a.

The memorandum decisions of the United States District Court for the District of Massachusetts (Skinner, D.J.), first dismissing the complaints against petitioner, and then granting respondents' motion to amend their complaints and denying petitioner's motion for reconsideration, have not been reported. They are reprinted in the appendix hereto, App. B, *infra*, 17a, App. C, *infra*, 27a and App. D, *infra*, 35a, respectively.

Jurisdiction

Invoking federal jurisdiction under 15 U.S.C. § 78aa, 29 U.S.C. § 1132, 18 U.S.C. § 1964(c), 28 U.S.C. § 1331 and the doctrine of pendent jurisdiction, the respondents brought these six consolidated actions in the United States District Court for the District of Massachusetts. On January 7, 1985, the District of Massachusetts granted respondents' motion to amend their complaints to permit respondents to allege vicarious liability against petitioner under the common law doctrine of apparent authority. App. C, *infra*, 27a. On February 15, 1985, the District of Massachusetts denied petitioner's motion for reconsideration. App. D, *infra*, 35a.

On May 13, 1985, the District of Massachusetts certified the issue herein for review pursuant to 28 U.S.C. § 1292(b), stating:

> I certify that my order of February 15, 1985 [denying petitioner's motion for reconsideration] involves a controlling question of law, that there is substantial ground for difference of opinion as evidenced by a split in the circuits, and that a reversal will terminate the litigation as to AZL.

App. E, *infra*, 39a.

On June 12, 1985, the First Circuit granted petitioner leave to appeal (App. F, *infra,* 40a) and on the appeal entered a judgment and opinion dated February 19, 1986, affirming the order of the District Court (App. A, *infra,* 1a). No petition for rehearing was filed in the First Circuit.

The jurisdiction of this Court to review the judgment of the First Circuit is invoked under 28 U.S.C. § 1254(1).

Statute Involved

The statute involved herein is Section 20(a) of the Securities Exchange Act of 1934 (the "1934 Act"), as it constitutes one of the interrelated components of the federal regulatory scheme governing transactions in securities embodied in the 1934 Act and in the Securities Act of 1933 (the "1933 Act"). Section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a), provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Statement of the Case

This case presents the important and unresolved issue of a corporation's (AZL's) civil liability under Section 10(b) of the 1934 Act and Rule 10b-5 of the Securities and

Exchange Commission for the alleged fraudulent misrepresentations of its chairman, committed entirely for the chairman's own personal gain and without any benefit to the corporation, simply because plaintiffs allege that the chairman acted with the apparent authority of the corporation.

The issue arises in the context of a conflict between *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), and *American Society of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. 556 (1982), as applied to the securities laws. Whereas *Ernst & Ernst* teaches that adherence to the statutory standards fashioned by Congress requires a showing of scienter to trigger liability under Section 10(b) of the 1934 Act, *Hydrolevel* permits the application of common law principles of vicarious liability, without scienter, to effectuate the purposes of the Sherman Antitrust Act. In the instant case, the First Circuit has applied *Hydrolevel* to the securities laws and has imposed Section 10(b) liability vicariously against AZL, even though AZL is not alleged to have acted with scienter. The circuits are split on whether the statutory standard of good faith embodied in Section 20(a), or the common law standard of strict vicarious liability should be applied in securities fraud cases, and the varying formulations are confusingly applied by the district courts. Clarification by this Court is urgently needed.

Facts and Prior Proceedings

These are six consolidated actions, including one class action, arising out of the collapse of an investment advisory company known as Atlantic Financial Management, Inc. ("Atlantic"). Atlantic had invested heavily, on be-

half of itself and its many customers, in the common stock of AZL, which was publicly traded on the New York Stock Exchange. Plaintiffs, who were customers of Atlantic, allege that AZL's chairman, Maurice Strong, falsely represented to Atlantic at various times that a significant merger of AZL was imminent.

Strong allegedly made these misrepresentations to Atlantic to induce Atlantic to purchase substantial amounts of AZL common stock and thereby cause the market price of AZL stock to rise. At the same time, it is alleged, Strong was secretely selling his own stock in AZL at substantial profits.[1] By December 23, 1981, the price of AZL stock reached what proved to be its highest level, $32 per share, and Atlantic had purchased 650,000 shares for its own account and for the accounts of its clients.

When a merger of AZL failed to materialize, the market price of AZL stock, beginning in late January 1982, began to decline. Plaintiffs allege that Strong continued to assure Atlantic that a merger was imminent and also represented that a group of persons solicited by Strong would purchase a million shares of AZL stock. No merger took place, and no such purchase occurred. By July 7, 1982, the price of AZL's stock declined to a low of $4.62 per share. Atlantic and its customers suffered significant losses.

The original complaints sought to hold AZL liable on the conclusory allegation that AZL had benefited from

1. There are other officers and directors of AZL who are defendants herein who are alleged to have acted similarly, but the principal actor is alleged to be Strong, and we will refer only to Strong herein for the purpose of presenting our reasons for granting the writ.

Strong's alleged misrepresentations. On July 31, 1984, the District Court dismissed the claims against AZL, ruling that the complaints on their face showed that the alleged fraudulent representations of Strong were not made for the benefit of AZL, but rather for Strong's personal benefit. AZL was not alleged to have sold any stock, and all of the authorized corporate statements issued by AZL were conceded to have been accurate.

Plaintiffs then sought leave to amend their complaints to allege, among other things, that Strong was acting with "at least apparent authority" when he disseminated the allegedly false information to Atlantic.

On January 7, 1985, the District Court allowed plaintiffs' motion for leave to amend, but only to the extent of permitting plaintiffs to sue AZL on the limited basis of Strong's "apparent authority." App. C, *infra,* 27a, 31a. At the same time, the District Court, reaffirmed its earlier ruling that the complaints did not, and could not consistently with other allegations therein, allege that Strong's alleged misrepresentations were for AZL's benefit, or that AZL benefited therefrom. App. C, *infra,* 27a, 30a.

AZL moved for reconsideration, arguing, *inter alia,* that common law agency principles of "apparent authority" should not be applicable to impose liability under Section 10(b) and Rule 10b(5) on a non-benefiting principal for securities frauds committed by its agents with "apparent authority" only. AZL argued that the "controlling persons" provision of the 1934 Act, Section 20(a), should be the sole basis for imposing such liability.

The District Court denied AZL's motion for reconsideration in a Memorandum and Order dated February 15, 1985 (App. D, *infra*, 35a), but on May 13, 1985, certified the issue for review pursuant to 28 U.S.C. § 1292(b), stating:

> I certify that my order of February 15, 1985 involves a controlling question of law, that there is substantial ground for difference of opinion as evidenced by a split in the circuits, and that a reversal will terminate the litigation as to AZL.

App. E, *infra*, 39a.

The Court of Appeals for the First Circuit granted leave to AZL to appeal on June 12, 1985. App. F, *infra*, 40a. On February 19, 1986, the Court of Appeals affirmed the order of the District Court. App. A, *infra*, 1a.

Reasons for Granting the Writ

I. This Court should decide whether Section 20(a) determines the vicarious liability of controlling persons, or whether common law principles of apparent authority apply instead.

The First Circuit, while recognizing that this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), restricts liability under Section 10(b) to "*primary* actors" who act with scienter, nevertheless reads *American Society of Mechanical Engineers, Inc.* v. *Hydrolevel, Corp.*, 456 U.S. 556 (1982), as endorsing the applicability of common law vicarious liability standards to innocent *non-actors* whose agents act with apparent authority only.

The Court of Appeals relied on a citation in *Hydrolevel* to two securities fraud cases, *Kerbs* v. *Fall River Indus-*

tries, Inc., 502 F.2d 731 (10th Cir. 1974), and *Holloway* v. *Howerdd*, 536 F.2d 690 (6th Cir. 1976), one of which precedes and the other of which does not discuss the significance of *Ernst*.[2] We respectfully suggest that this Court should resolve this issue, and not leave it to the district and circuit courts to draw an inference as to what this Court would do based on this Court's citations in *Hydrolevel* to *Kerbs* and *Holloway*. The issue is an important one for several reasons.

First, since the proliferation of private rights of action in the 1970's, the federal courts have been struggling to reconcile the statutory measure of vicarious liability (Section 20(a) of the 1934 Act)—which allows controlling persons to defend on the grounds of their good faith—with common law principles of apparent authority, which essentially impose liability without fault. As discussed in Point V, *infra*, there is an acknowledged split among the circuits and confusion in the district courts with regard to this issue.

Second, the reflexive application of common law principles of apparent authority creates a tension with this Court's decision in *Ernst & Ernst* v. *Hochfelder*. That decision requires deference to the particularized standards of liability fashioned by Congress, including, we respectfully submit, Section 20(a) of the 1934 Act. Section 20(a) constitutes the Congressional standard for imposing vicarious liability and provides a comprehensive and flexible

2. In addition, the issue of the applicability or non-applicability of common law vicarious liability principles to securities fraud actions does not appear to have been raised in *Kerbs*, and in *Holloway*, the Sixth Circuit noted specifically that: "The Supreme Court has not resolved the issue." 536 F.2d at 695.

framework for adjudicating the liability of controlling persons. It also readily meets the public policy concerns expressed by the First Circuit of encouraging corporate control of officers and directors to alleviate the burden of loss from an innocent victim. *See* Points II and III, *infra*.

Third, the *Hydrolevel* decision, which is the only decision of this Court to which the federal courts can look for guidance on this issue, involved an entirely different federal statute and policy. In enacting the Sherman Act, Congress provided no standards for the imposition of vicarious liability. In contrast, when Congress enacted the securities laws, it fashioned a particularized standard for the imposition of such liability in both Section 20(a) of the 1934 Act and Section 15 of the 1933 Act. *See* Point IV, *infra*.

Finally, without guidance from this Court in the form of a decision involving the securities laws, there will continue to be protracted pretrial proceedings below to resolve the issue. A good example is the instant case. The issue of AZL's liability for Strong's alleged misconduct has been the subject of pretrial proceedings herein for almost two years, since the date of AZL's first motion to dismiss on May 25, 1984.

II. The language and legislative history of Sections 15 and 20(a) shows that Congress intended the standards of liability of Sections 15 and 20(a), and not those of the common law, to govern vicarious liability under the securities laws.

As this Court noted in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. at 200, "[i]t is . . . evident that Congress fashioned standards of fault in the express civil remedies in the 1933

and 1934 Acts on a particularized basis. Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section."

This Court noted by way of example that "[i]n some circumstances and with respect to certain classes of defendants" Congress created "express liability predicated upon a failure to exercise reasonable care" (e.g., liability of "experts" under Section 11(b)(3)(B) of the 1933 Act, 15 U.S.C. § 77k(b)(3)(B); whereas "in other situations good faith is an absolute defense" (e.g., misleading statements in documents filed pursuant to the 1934 Act, Section 18 of the 1934 Act, 15 U.S.C. § 78r); "[a]nd in still other circumstances Congress created express liability regardless of the defendant's fault" (e.g., issuer liability for a false registration statement under Section 11(a) of the 1933 Act, 15 U.S.C. § 77k(a)). 425 U.S. at 200.

Thus, the very structure of the securities laws belies the First Circuit's decision imposing vicarious liability on AZL. "In each instance that Congress created express civil liability in favor of purchasers or sellers of securities," this Court also stated in *Ernst & Ernst*, "it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake." And in support thereof, this Court cited, *inter alia*, both Section 15 of the 1933 Act and Section 20 of the 1934 Act. 425 U.S. at 207.

And even more to the point, in footnote 28 on page 209 of 425 U.S., this Court said that Section 20 of the 1934 Act "exculpates a defendant who 'acted in good faith and

did not . . . induce the act . . . constituting the violation . . . .' " Clearly, this Court did not interpret the "controlling persons" section as being limited to situations involving dummy corporations, as the First Circuit did herein, but acknowledged that its purpose was to "exculpate" innocent parties sought to be made liable, simply because they were "controlling persons."

The language of Section 20(a) itself clearly indicates the Congressional intention that controlling persons not be held strictly liable. Section 20(a) of the Securities Exchange Act provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a).

In enacting Section 20(a) and the cognate provision of the 1933 Act (Section 15), Congress carefully considered the standards for imposing derivative liability on "controlling persons." The Senate initially proposed an "insurer's liability" standard, which, in effect, would have imposed strict liability against controlling persons. S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933) (The Fletcher Report). The House, however, rejected liability without fault and instead proposed a "fiduciary standard" which included a duty of due care. H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933).

Congress adopted the House version, which contained the good faith defense.

As originally enacted, Section 15 of the 1933 Act did not contain a "good faith" defense provision. This section was quickly amended in 1934 to make it conform to Section 20(a), which was then being enacted. In promulgating the amendment to Section 15, the House Conference Committee Report stated:

> Section 15 [of the 1933 Act] is proposed to be amended so as more accurately to carry out its real purpose. *The mere existence of control is not made a basis for liability* if it is shown that the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts upon which the liability of the controlled person is alleged to be based.

H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 42 (1934) (emphasis added).[3]

The legislative history of the controlling persons provisions thus indicates that Congress did not intend to make controlling persons liable absent a showing of fault. As the Third Circuit stated in *Rochez Bros., Inc.* v. *Rhoades*, 527 F.2d 880 (3d Cir. 1975), the passage of the 1934 amend-

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3. In *Ernst & Ernst* v. *Hochfelder*, 425 U.S. at 209, fn. 27, this Court described Section 15 of the 1933 Act as follows:

> Section 15 of the 1933 Act, as amended by § 208 of Title II of the 1934 Act, makes persons who "control" any person liable under § 11 or § 12 [of the 1933 Act] liable jointly and severally to the same extent as the controlled person, unless he "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."

Thus, this Court read Section 15, as petitioner proposes herein, as a *limitation* on liability, and not as an *extension* of liability.

ment to Section 15, taken together with the concurrent passage of Section 20(a), indicates:

> that Congress did not intend anyone to be an insurer against the fraudulent activities of another. What Congress did intend was to impose liability on those who were controlling persons and who were "in some meaningful sense culpable participants in the fraud perpetrated by controlled persons."

Id. at 885, quoting *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc).

III. Section 20(a) provides a coherent and flexible framework for adjudicating the liability of controlling persons.

The Court of Appeals here, in holding that a claim could be stated against AZL based on apparent authority, effectively nullified Section 20(a)'s good faith defense and permitted liability to be imposed without fault. The Court of Appeals found that Section 20(a) does not provide the exclusive means of imposing derivative liability on corporations such as AZL, reasoning that when Congress adopted the Securities Exchange Act, it meant to incorporate common law principles. According to the Court of Appeals' theory, Section 20(a) should be read to expand, not to supplant, common law principles, "presumably . . . [to reach] persons beyond the reach of ordinary common law agency liability." App. A, *infra*, 10a.

4. The First Circuit noted the purpose of Section 15 of the 1933 Act, the counterpart to Section 20(a), "as expressed by one of its authors, Thomas G. Corcoran, is 'to prevent evasion of the [Act] . . . by organizing dummies who will undertake the actual things forbidden by the [Act].'" (App. A, *infra*, 9a.) Why these dummy entities would be beyond the reach of the securities laws "as the primary actors" under common law principles such as agency or piercing the corporate veil is not explained.

The Court of Appeals thus ruled that when Congress enacted Section 20(a), it was not defining a standard of liability generally applicable to controlling persons, but was creating a specialized type of liability, applicable in only certain undefined circumstances, with an exception for good faith that was also applicable in only these limited situations.

This analysis is fraught with problems. First, it rejects the teaching of *Ernst & Ernst* v. *Hochfelder*, 425 U.S. at 200, that in enacting the securities laws, Congress fashioned standards of fault on a particularized basis.

Second, it is difficult to think of a single instance where, under the Court of Appeals analysis, Section 20(a) would create a liability that would not already exist under traditional common law principles of agency or piercing the corporate veil. If, as the Court of Appeals suggests, Section 20(a) was not meant to be generally applicable as the standard for vicarious liability, then Congress enacted a superfluous statute, imposing liability only on people who would already be liable under common law principles.

In holding that common law principles of apparent authority should be applied to the securities laws, the First Circuit noted two policy reasons "for believing that the 'direct or indirect' language of the Securities [Exchange] Act encompasses this kind of common law agency liability": (1) a policy of "fairness" to favor a victim over a principal of a perpetrator; and (2) to encourage stronger corporate control of officers. App. A, *infra*, 8a. Both of these concerns are met, however, by the application of Section 20(a). Section 20(a) provides that a controlling per-

son will be liable unless it acted in good faith or induced the act. If it did not act in good faith, the controlling person bears the loss over the "innocent victim." If the controlling person did act in good faith, Section 20(a) perceives that it, too, was an innocent party, and leaves to the primary actor the burden of the loss.

Applying common law principals of vicarious liability is no more likely to encourage corporate control of officials than Section 20(a). A corporation that does not adequately prevent fraud clearly cannot meet the standard of good faith. Here however, there was nothing AZL could have done to stop Strong from making the alleged misstatements. To impose liability in this situation, without permitting a good faith defense, is punitive, and serves no purpose that is important to the securities laws.

An apt example of how Section 20(a) can be applied to effect the policy concerns alluded to by the First Circuit is *SEC* v. *First Securities Co.*, 463 F.2d 981 (7th Cir.), *cert. denied sub. nom, McKy* v. *Hochfelder*, 409 U.S. 880 (1972), a case arising out of the *Ernst & Ernst* v. *Hockfelder* fraud. The plaintiffs in *First Securities* were customers of First Securities, a broker-dealer. Leston Nay, the president and 92% stockholder of First Securities, offered each of the plaintiffs the opportunity to invest in a high yield "escrow account." The accounts were fraudulent. The scheme, however, did not benefit First Securities, and it was not intended to. It was a scheme for Nay's personal gain only. Nay committed suicide, and plaintiffs sued First Securities, alleging both violations of Section 10(b) and common law fraud.

The Seventh Circuit held First Securities liable under principles of apparent authority for *common law fraud.*

In analyzing the liability of First Securities under the 1934 Act, however, it did not use common law principles, but rather the standards of Section 20(a). Using Section 20(a), the Court found that First Securities had failed to supervise Nay and had, by acceding to a rule that no one but Nay could open mail addressed to Nay's attention, "directly facilitated the prolonging of the fraud, if not its very inception." *Id.* at 987.

In sum, Section 20(a) provides a coherent framework for adjudicating controlling persons liability. It is flexible enough to accommodate the Court of Appeals' policy purposes, yet does not do violence to the statutory scheme enacted by Congress. Where, as here, a corporation acted in good faith and did not directly or indirectly induce the violation, no liability will lie. That is as Congress intended it should be.

IV. The rule of *Hydrolevel*, which vindicates the policies of the Sherman Act, should not be applicable to determine liability under the securities laws, where Congress created a statutory scheme, fashioning standards of fault on a particularized basis.

The Court of Appeals cites *American Society of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. 556 (1982), in support of its argument that common law agency principles of apparent authority should be read into the 1934 Act. In *Hydrolevel*, an officer of a private company used his position in the American Society of Mechanical Engineers ("ASME") to damage a competitor's business. Because ASME cloaked its officials with the authority "to affect the destinies of businesses and . . . the power to frustrate competition in the marketplace," *id.* at 571, this Court held that applying apparent authority principles to the antitrust laws was consistent with the

Congressional intent to encourage competition. The Court found:

> In this case, we can honor the statutory purpose best by interpreting the antitrust private cause of action to be at least as broad as a plaintiff's right to sue for analogous torts, *absent indications that the antitrust laws are not intended to reach so far.*

Id. at 569 (emphasis added).

In the securities laws, by contrast, there are "indications" to the contrary.

First, the language and legislative history of Sections 15 and 20(a) are strong indications to the contrary. *See* Point II, *supra.*

Second, unlike the antitrust laws, the securities laws have sections specifically directed to the liability of controlling persons, to wit, Sections 15 and 20(a). The Sherman Act has no "controlling persons" provision, and absent the incorporation of common law principles, there would be no liability for principals at all under the Sherman Act.

Third, the potential remedial effect noted by this Court in *Hydrolevel* is absent here. In *Hydrolevel,* this Court was influenced by the fact that by imposing liability on the particular principal in that case, ASME, "it is much more likely that similar antitrust violations will not occur in the future." 456 U.S. at 572. Indeed, ASME actually instituted new procedures in response to the *Hydrolevel* suit. 456 U.S. at 574, fn. 13. AZL could not do anything comparable. There were no new procedures which AZL did, or could, institute to prevent its next chairman, or any other officer or director, from similarly misleading investors in its stock.

There was no lack of supervision; no lack of appropriate rules. A high level corporate officer is alleged simply

to have perpetrated a fraud by making misrepresentations to aid his own stock positions, and plaintiffs' investment advisor listened to these "insider" statements in preference to relying on proper corporate disclosures. Should a corporation in AZL's position send out press releases to advise brokers and investment advisors that its officers are not allowed to leak false inside information?

Where a corporation such as AZL does not act in good faith, or where it directly or indirectly induces the violation, an appropriate remedial purpose will be served by imposing liability under the securities laws. But not otherwise, and the *Hydrolevel* decision does not go to these strictly securities law-related considerations.

V. There is a sharp conflict among the circuits, and cases within certain circuits have been decided inconsistently, resulting in confusion among the district courts.

With the exception of the Eleventh Circuit, every circuit court of appeals has ruled on whether common law agency principles can be applied to impose vicarious liability under the securities laws. The circuits are split, as both the Court of Appeals and the District Court recognized.[5] The Third,[6] Fourth,[7] Eighth[8] and Ninth Cir-

5. App. A, *infra*, 1a; App. E, *infra*, 39a.

6. *Rochez Bros., Inc.* v. *Rhoades*, 527 F.2d 880 (3d Cir. 1975); *Thomas* v. *Duralite Co.*, 524 F.2d 577 (3d Cir. 1975). *But see Sharp* v. *Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 445 U.S. 938 (1982), holding that *Rochez* does not apply to accountants for public policy reasons.

7. *Carpenter* v. *Harris, Upham & Co.*, 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). *But see Frankel* v. *Wyllie & Thornhill, Inc.*, 537 F. Supp. 730, 742 (W. D. Va. 1982).

8. *Myzel* v. *Fields*, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (liability of controlling persons "is governed neither by principles of agency nor conspiracy").

cuits[9] have generally held that section 20(a) is the exclusive means of imposing 1934 Act liability on principals. The Second,[10] Fifth,[11] Sixth,[12] Seventh,[13] Tenth[14] and now the First Circuits have imposed liability under common law agency principles.

Even where the courts of appeals have stated a clear rule, there is confusion. The Third Circuit, for example, recently held that in spite of the general rule prohibiting *respondeat superior* liability laid down in the leading case of *Rochez Bros., Inc.* v. *Rhoades*, 527 F.2d 880 (3d Cir. 1975), for public policy reasons, *respondeat superior* may be used to impose liability on an accounting firm that failed to supervise an associate rendering a tax opinion. *Sharp* v. *Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982). A district court in the Fourth Circuit recently held that *Carpenter* v. *Harris, Upham & Co.*, 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979), did not preclude the imposition of liability under *respondeat superior*. *Frankel* v. *Wyllie & Thornhill, Inc.*, 537 F. Supp. 730, 741 (W. D. Va. 1982). Another district

9. *Chirstoffel* v. *E.F. Hutton & Co.*, 588 F.2d 665, 667 (9th Cir. 1978); *Zweig* v. *Hearst Corp.*, 521 F.2d 1129, 1132 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); *Kamen & Co.* v. *Paul H. Aschkar & Co.*, 382 F.2d 689, 697 (9th Cir. 1967), *cert. granted*, 390 U.S. 942, *cert. dismissed*, 393 U.S. 801 (1968).

10. *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir. 1980), *cert. denied sub nom., Wooden, Walker & Co.* v. *Marbury Management, Inc.*, 449 U.S. 1011 (1981).

11. *Paul F. Newton & Co.* v. *Texas Commerce Bank*, 630 F.2d 1111 (5th Cir. 1980).

12. *Holloway* v. *Howerdd*, 536 F.2d 690 (6th Cir. 1976).

13. *Henricksen* v. *Henricksen*, 640 F.2d 880 (7th Cir.) *cert. denied*, 454 U.S. 1097 (1982).

14. *Kerbs* v. *Fall River Industries, Inc.*, 502 F.2d 731 (10th Cir. 1974).

court has held that it does. *Haynes* v. *Anderson & Strudwick, Inc.*, 508 F. Supp. 1303 (E. D. Va. 1981).

Recognizing that a blanket acceptance of common law principles of vicarious liability imposes liability without fault, several courts—including the First Circuit in this case—have refused to endorse a wholesale importation of such principles into the securities laws:

> As the Second Circuit has stated, the fact that use of common law agency concepts may be appropriate in some circumstances does not mean that we should import them where this will not further the policies of the Securities [Exchange] Act.

App. A, *infra*, 15a, *citing SEC* v. *Geon Industries Inc.*, 531 F.2d 39, 54 (2d Cir. 1976); *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975). Yet, these same courts give no indication of what those circumstances might be. By refusing to fashion a rule to guide the district courts, these circuit courts create confusion and uncertainty where Congress has mandated uniformity.

The result is that the district courts are left without guidance on this important issue. Are common law principles applicable? If so, are they applicable in every case? If not, in what cases are they applicable and why? The absence of a rule expressing clear categories and standards has resulted in protracted and expensive pretrial proceedings on issues that should be resolved on the pleadings.[15]

15. In *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739 (1975), the Court noted Judge Friendly's warning that "unduly expansive imposition of civil liability will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers. . . ." *Id.* at 739, *quoting*

(footnote continued on next page)

In 1934 Congress adopted a framework for the imposition of vicarious liability: Section 20(a). The lower courts have been attempting to reconcile Section 20(a) with common law agency principles for over ten years. The decisions conflict. This is an important issue, and it is time for this Court to consider it.

Conclusion

For the foregoing reasons, petitioner respectfully submits that the writ should be granted.

Respectfully submitted,

ALVIN K. HELLERSTEIN
(Counsel of Record)
THOMAS FARBER
STROOCK & STROOCK & LAVAN
7 Hanover Square
New York, New York 10004
(212) 806-5400

and

JEROME GOTKIN
GORDON P. KATZ
WIDETT, SLATER & GOLDMAN, P.C.
60 State Street
Boston, Massachusetts 02109
(617) 227-7200

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (concurring opinion) *cert. denied*, 394 U.S. 976 (1970). This sentiment is especially applicable here, where plaintiffs, including a class, ask AZL's current shareholders to respond in multi-millions of dollars in damages for a fraud in which AZL had no part.

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE FIRST CIRCUIT

No. 85-1454

IN RE:

ATLANTIC FINANCIAL MANAGEMENT, INC.,
SECURITIES LITIGATION,

Petitioners.

JUDGMENT

Entered: February 19, 1986

This cause came on to be heard on appeal from the United States District Court for the District of Massachusetts, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The order of the district court is affirmed.

By the Court:

/s/ FRANCIS P. SCIGLIANO
Clerk.

[cc: Messrs: Gotkin and Schneider]

Appendix A

UNITED STATES COURT OF APPEALS

FOR THE FIRST CIRCUIT

No. 85-1454

IN RE:

ATLANTIC FINANCIAL MANAGEMENT, INC.
SECURITIES LITIGATION,

Petitioners.

ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MASSACHUSETTS

[Hon. Walter Jay Skinner, *U.S. District Judge*]

Before

Coffin and Breyer, *Circuit Judges,*
and Wyzanski,* *Senior District Judge.*

Jerome Gotkin, with whom *Gordon P. Katz, Steven M. Sayers, Widett, Slater & Goldman, P.C., Alvin K. Hellerstein,* and *Stroock & Stroock & Lavan* were on brief for appellant AZL Resources, Inc.

Peter J. Schneider with whom *Lawrence G. Cetrulo, Burns & Levinson, Samuel Adams* and *Warner & Stackpole* were on brief for appellees.

February 19, 1986

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* Of the District of Massachusetts, sitting by designation.

Appendix A

BREYER, *Circuit Judge.* This appeal presents a certified question, 28 U.S.C. § 1292(b), arising in a Securities Act misrepresentation case. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b); Rule 10b-5, 17 C.F.R. § 240.10b-5. The plaintiffs in the case claim that Maurice Strong, the chairman of AZL Resources, Inc., misrepresented certain facts as a result of which they bought AZL stock and later (when the stock's price declined) lost money. The plaintiffs want to recover damages for the misrepresentation, not only from Strong, but also from AZL, Strong's corporate employer. They assert a common law theory of agency—based on "apparent authority"—as a ground for holding the corporation 'vicariously' liable for Strong's misdeeds.

The certified question concerns the relationship between a special section of the Securities Act of 1934, section 20(a), 15 U.S.C. § 78t(a), and various common law theories of vicarious liability (of which "apparent authority" is one). That section reads as follows:

> *Every person who, directly or indirectly, controls any person liable* under any provision of this chapter or of any rule or regulation thereunder *shall also be liable* jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, *unless the controlling person acted in good faith and did not directly or indirectly induce the* act or acts constituting the *violation* or cause of action.

(Emphasis added.)

The significance of this section here lies in the contrast between its proviso and the common law. The proviso requires a finding of liability unless the controlling person 1) "acted in good faith" and 2) did not "induce" the violation. By way of contrast, common law agency theories may impose liability upon a principal or an employer without these two preconditions. The case before us asks whether the Securities Act means that section 20(a) is an *exclusive* remedy. That is to say, does the existence of this section foreclose holding a principal (say, a corporation) or an employer (who 'controls' an agent or employee) 'vicariously' liable when the proviso's two conditions are not met?

The circuits seem to be split about the proper answer to this question. The Second, Fourth, Fifth, Sixth, Seventh and Tenth Circuits have held that section 20(a) does not constitute an exclusive substitute for vicarious liability that might otherwise exist. *E.g., Marbury Management, Inc.* v. *Kohn,* 629 F.2d 705, 712-16 (2d Cir.), *cert. denied,* 449 U.S. 1011 (1980); *John Hopkins University* v. *Hutton,* 422 F.2d 1124, 1130 (4th Cir. 1970), *cert. denied after later appeal,* 416 U.S. 916 (1974); *Paul F. Newton & Co.* v. *Texas Commerce Bank,* 630 F.2d 1111, 1118-19 (5th Cir. 1980); *Holloway* v. *Howerdd,* 536 F.2d 690, 694-95 (6th Cir. 1976); *Fey* v. *Walston & Co., Inc.,* 493 F.2d 1036, 1051-52 (7th Cir. 1974); *Kerbs* v. *Fall River Industries, Inc.,* 502 F.2d 731, 740-41 (10th Cir. 1974). The Ninth, and (with exceptions) the Third Circuits, have held the contrary. *Zweig* v. *Hearst Corp.,* 521 F.2d 1129, 1132-33 (9th Cir.), *cert. denied,* 423 U.S. 1025 (1975); *Sharp* v. *Coopers & Lybrand,* 649 F.2d 175, 180-84 (3d Cir. 1981), *cert. denied,* 455 U.S.

938 (1982); *Rochez Brothers, Inc.* v. *Rhoades,* 527 F.2d 880, 884-86 (3d Cir. 1975). We have not previously considered whether, despite section 20(a), principals may be held 'vicariously' liable for the 'securities related' misrepresentations of their agents. *But cf. Holmes* v. *Bateson,* 583 F.2d 542, 560 (1st Cir. 1978) (discussing related questions). We now consider this question; and we join the majority expressly—at least in respect to the common law "apparent authority" theory here at issue.

Because there are several different common law agency theories that may lead tc 'vicarious liability' and because not all courts use the same terminology in respect to each, it may help to clarify the exposition of our reasons if we divide this opinion into two parts. First, we shall explain the basis for liability that would exist in this, and similar cases, in the absence of section 20(a). Second, we shall ask whether, or when, the existence of section 20(a) might make a difference.

I

In the absence of section 20(a) a corporate principal's (or employer's) 'vicarious' liability for the misrepresentations of an agent (typically an employee) must find its source in Securities Act § 10(b)—the statutory provision that makes it "unlawful for any person, directly or indirectly . . . to use . . . any manipulative or deceptive device" in connection with the purchase or sale of securities. The "majority rule" circuits have at least implicitly read these words as encompassing some kinds of vicarious liability. (See cases cited at pp. 3-4, *supra.*) And, the Supreme Court, while restricting the liability of

primary actors to persons who act with "*scienter*," *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), has nonetheless cited with approval cases imposing 'vicarious' liability upon corporations who employ those who knowingly or recklessly make misrepresentations. *American Society of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. 556, 568 (1982) (hereinafter *ASME*), citing with approval *Holloway, supra; Kerbs, supra.*

These legal facts are not surprising. The common law has long imposed vicarious liability upon principals arising from torts committed by their agents. Whether broad language, such as that found in the Securities Act, embraces such principles is a matter of statutory interpretation based upon congressional intent. *ASME*, 456 U.S. at 569-70. And, the courts have tended to read congressional statutes that impose tort-like liability to embrace at least some of these well established common law agency principles, where language permits and doing so furthers basic statutory purposes. *Id.* at 568 (liability imposed upon principals for antitrust violations committed by agents). The courts must also decide *which* common law rules apply under the statutory scheme. And, it will help our exposition if, for this purpose, we divide relevant agency liability rules into three different kinds.

First, the common law typically holds principals liable when an agent's tortious representation is *actually authorized*, whether the agent's authority be express or implied. *Restatement (Second) of Agency* §§ 7, 257 (1958); W. Seavey, *Handbook of the Law of Agency* § 91 (1964). Such liability is not of great practical importance when

the principal is a corporation, however, for a corporation (its charter, bylaws, directors' actions, etc.) rarely, if ever, *actually* authorizes torts. (Indeed, were it to do so, the corporation might be 'directly' rather than 'vicariously' liable.)

Second, a corporation's liability for an agent's misrepresentations may rest upon a theory of "*apparent authority.*" *Restatement (Second) of Agency* § 8; *cf. id.* at § 8B (a related, but distinguishable theory of 'estoppel'). The agent's tortious action, while not actually authorized by the corporation, appears so to those adversely affected. Vicarious "[l]iability is based upon the fact that the agent's position facilitates the consummation of the fraud, in that from the point of view of the third person the transaction seems regular on its face and the agent appears to be acting in the ordinary course of the business provided to him." *ASME,* 456 U.S. at 566, quoting with approval from *Restatement (Second) of Agency* § 261, comment a, p. 571. Courts have commonly imposed liability based on "apparent authority" upon a corporation in both state and federal "misrepresentation" cases —particularly when the person making the misrepresentation is an important corporate official. *See* 10 R. Eickhoff, *Fletcher on Corporations* § 4886 (1978 & Supp. 1985).

A third basis for imposing vicarious liability consists of what commentators have called "*inherent agency powers*" or (in the master/servant context) "respondeat superior" or sometimes simply "the agent's position." *Restatement (Second) of Agency* § 8A; W. Seavey, *supra,* at § 8F and § 58. We shall for convenience refer to this basis of liability as "status based" (in contrast with

"authority based") liability. This non-authority based vicarious liability rests upon certain important social and commercial policies. *See, e.g.*, W. Seavey, *supra*, at § 58 ("[T]he business enterprise should bear the burden of the losses created by the mistakes or overzealousness of its agents [because such liability] stimulates the watchfulness of the employer in selecting and supervising the agents."); and at § 61 ("[T]he principal, [having] . . . the opportunity of investigating the agent . . . should guarantee the [agent's] honesty"). The precise scope of "status based" liability is unclear, with liability often depending upon the relationship of the social policy to the type of "principal/agent" circumstance at hand. *Id.* at § 8F. A "master," for example, is not held vicariously liable (on these grounds) for the torts of a "servant" where the servant does not act for the purpose of serving his master but is on a 'frolic of his own.' *Restatement (Second) of Agency* § 235 (no liability when the servant acts "with no intention to perform it as a part or incident to a service on account of which he is employed"). Yet, a principal (even though not a 'master') *is* liable for tortious misrepresentations of an agent (even though not a 'servant') even if the agent "acts entirely for his own purposes, unless the [injured person] . . . has notice of this." *Id.* at § 262.

The case before us is of the *second* kind; the *"apparent authority"* of a high corporate officer. There are strong reasons for believing that the 'direct or indirect' language of the Securities Act encompasses this kind of common law agency liability. For one thing, as between the corporation that has placed the official in a position to invoke

its authority (though improperly) and a victim, it seems fairer that the former bear the burden of an uncompensated loss. Further, imposing such liability will encourage corporate officials to prevent unauthorized (but 'apparently authorized') misrepresentations, thereby helping to achieve an important Securities Act purpose. Moreover, both related state "misrepresentation" law (which the federal act leaves untouched, 15 U.S.C. § 78bb(a)), and federal cases (quoted by the Supreme Court with approval) apply "apparent authority" liability principles. *ASME*, 456 U.S. at 568, citing with approval *Holloway, supra; Kerbs, supra.* Thus, we have little doubt that, in the absence of section 20(a) we should read the Securities Act of 1934 as imposing vicarious liability upon a corporation for the "apparently authorized" misrepresentations of a high official.

II

We turn now to the question directly before us—whether section 20(a) precludes the imposition of this kind of vicarious liability that would otherwise exist. We think not for several reasons. First, the legislative history of section 20(a) reveals no such intent. Though the relevant written history is sparse, it is significant for it makes clear that the section was aimed at expanding liability, rather than contracting it. Section 20(a) was modeled on section 15 of the 1933 Securities Act, 15 U.S.C. § 77o, and it has an identical purpose. That purpose, as expressed by one of its authors, Thomas G. Corcoran, is "to prevent evasion of the [Act] . . . by organizing dummies who will undertake the actual things forbidden by the [Act]." Hearings

before the Senate Comm. on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.), 73 Cong., 1st Sess, pt. 15, at 6571 (1934). Congress thus saw this section as *imposing* liability upon, say, a shareholder or a director who controlled a corporation engaged in misrepresentation, presumably including persons beyond the reach of ordinary common law agency liability. *See id.* at 6639; 2 Federal Securities Code § 793 & comment (3)(b). There is no statement of purpose suggesting that Congress saw this section as *removing* liability that the Act would otherwise impose upon a corporation that 'controlled' an officer or director. Other circuits have analyzed the statute's history in some detail; and, without simply repeating their analysis of the history, we adopt their conclusions. *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975); *Paul F. Newton & Co.*, 630 F.2d at 1115-16.

Second, the reasons, drawn from the legislative history, offered by those circuits with a different view and by appellants, do not convince us. The appellants refer to the language of the statute, noting that section 20(a) in essence says, "Every person who . . . controls any person liable . . . shall also be liable . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act . . . ." Even assuming, as we do, that the word "control" includes the agency relation (*see* 15 U.S.C. § 77; H.R. Rep. No. 1383, 73d Cong., 2d Sess. 26 (1934)), this language need not be read as providing an *exclusive* route for imposing liability. Section 20(a) does not *say* that it is exclusive; and its proviso ("unless . . .") is

naturally read as referring to the (potentially *non*exclusive) liability which section 20(a) *itself* provides.

Appellants refer to the fact that the House and Senate differed in the versions of section 20(a) that they initially presented. The Senate wanted to impose an "insurer's liability" on controlling persons; while the House chose a "fiduciary standard" which eventually became the law. *See* S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933) (The Fletcher Report); H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933); H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 27 (1933). Yet, this fact is not determinative once section 20(a) is seen as nonexclusive, for, in that event, the different versions refer to *liability under the section*, not to *all* liability that the statute may impose upon one who meets the definition of 'controlling person.' Appellants also point to statements that legislators made in 1934 when they added a proviso to section 15 of the 1933 Act, to the effect that the "mere existence of control is not made a basis for liability." H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 42 (1934). Yet, again, this statement in context refers to the liability *created* by section 15, not to liability that would exist anyway in its absence. To read it otherwise is to ignore the main thrust of sections 15 and 20(a).

Third, to read section 20(a) as providing the *exclusive* basis for imposing liability on one "who, directly or indirectly, controls any person liable" is to read it as having worked considerable change in existing liability assumptions. On this reading, most corporations, typically liable vicariously under state misrepresentation law for their officers' acts, would often escape liability under federal

law. *See* 10 *Fletcher on Corporations* § 4886. Yet, the legislative history nowhere refers to any such important difference between state and federal law. In fact, by explicitly including corporations in its definition of "person," 15 U.S.C. § 77(b)(2), the statute seems to foresee that corporations will be held liable. *See Management Dynamics, Inc.*, 515 F.2d at 812. Yet, since corporations can act only through agents, how, without principles of vicarious liability, (or twisting the meaning of "good faith") could this ordinarily be done?

Fourth, as we have previously noted, the vast majority of circuits have concluded that the "controlling person" provision of section 20(a) is not an exclusive basis for imposing secondary liability under the Securities Act and thus that common law principles of vicarious liability are applicable to section 10(b) and Rule 10b-5 violations. *See* L. Loss, *Fundamentals of Securities Regulations* 1181 (1983) ("The Code follows the majority view, which recognizes common law liability [of a principal for the acts of its agents], so that the [section 20(a)] defenses are available only when the defendant controls as a holding company or in some other nonagency way.") We disagree with appellants' argument that the Fourth and Eighth Circuits favor their views, as we find recent cases in those circuits that ally them with the majority. *Metge* v. *Baehler*, 762 F.2d 621, 630-31 (8th Cir. 1985), *aff'g* 577 F. Supp. 810 (S.D. Iowa 1984), *cert. denied*, 54 U.S.L.W. 3460 (1986); *Carras* v. *Burns*, 516 F.2d 251, 259 (4th Cir. 1975); *Johns Hopkins University*, 422 F.2d at 1130; *Frankel* v. *Wyllie & Thornhill, Inc.*, 537 F. Supp. 730, 740-42 (W.D. Va. 1982).

Moreover, we believe the persuasive force of the opinions of the Ninth and Third Circuits, in respect to the "exclusive" nature of section 20(a), is limited by the fact that the cases there in issue involved circumstances where traditional agency principles *themselves* seemed to prohibit, or caution against, liability. The leading Ninth Circuit case of *Zweig* v. *Hearst Corp., supra,* involved a newspaper's financial columnist who published a false statement about a company in whose stock he had invested. The court did not see the case as dealing with "apparent authority." (Whether the columnist was "apparently authorized" to make his statements on behalf of the newspaper is doubtful.) *See* W. Seavey, *supra,* at § 8D. And, the very question that seemed to disturb the court—the practicality of strict supervision—seems relevant to the scope of "status based" liability under common law. *See* Seavey, *supra,* at § 92E. *See also Christoffel* v. *E.F. Hutton & Co., Inc.,* 588 F.2d 665 (9th Cir. 1978). In the earlier case of *Kamen & Co.* v. *Paul H. Aschkar & Co.,* 382 F.2d 689 (9th Cir.), *cert. granted,* 390 U.S. 942, *cert. dismissed,* 393 U.S. 801 (1967), on which *Zweig* based its conclusion regarding the "exclusivity" of section 20(a), the court specifically held that the principal was *not* liable under traditional agency principles; and it held that section 20(a) negated certain of the appellants' *additional* theories of liability. *Id.*

The Third Circuit began its leading "minority view" case, *Rochez Brothers, Inc.* v. *Rhoades,* 527 F.2d at 884, by noting that the corporate agent had "acted as an individual for his own account and the defrauded party knew that the officer was not acting for the corporation." Thus, *Rochez* was in fact a case without any basis for liability under tra-

ditional common law agency principles. Nothing in the case suggests the presence of "actual authority"; while the victim's *knowledge* precludes both "apparent authority" and "status based" liability. *Restatement (Second) of Agency* § 262. Appellants read *Rochez* as expressing the fear that broad 'agency based' liability "would . . . impose a duty on a corporation to supervise and oversee the activities of its directors and employees when they are dealing with their own corporate stock as individuals, and not for the corporation or for the benefit of the corporation." *Rochez,* 527 F.2d at 885. In that circuit's view, such liability "would violate the legislative purpose and effectively nullify the 'controlling person' provision of the Act." *Id.* at 885-86. But, the extent to which the premise of this argument is valid depends upon *which* agency principles courts read into the Act, and where and how they apply them. As we have previously pointed out, courts have applied vicarious liability principles flexibly in accordance with their underlying policy purposes and the purposes of the statute into which the courts have read them. *See SEC* v. *Geon Industries, Inc.,* 531 F.2d 39 (2d Cir. 1976); *Management Dynamics, Inc., supra.* Indeed, even the Third Circuit has denied the exclusivity of section 20(a) by accepting the imposition of vicarious liability in situations where the employer has "a duty to exercise a high standard of supervision" or where "the employee was a high level officer or director of the employer, the employer was a brokerage firm, or both." *Sharp,* 649 F.2d at 182. A flexible application of vicarious liability principles should adequately protect section 20(a)'s objectives from erosion. We do not see why reading section 20(a) as *exclusive* of all agency based liability is necessary to do so.

Appendix A

III

In sum, we conclude that section 20(a) does not preclude the assertion of liability—based on common law notions of "apparent authority"—against a corporation for the misrepresentations of an important corporate officer. We state this conclusion narrowly, however, for reasons that, by now, should be apparent. First, the *extent* to which a federal statute, such as the Securities Act, embraces common law agency principles, depends (as the Supreme Court stressed in the antitrust context) upon the extent to which their adoption is consistent with the statute's language and furthers its purposes. *ASME,* 456 U.S. at 569-70. As the Second Circuit has stated, the fact that use of common law agency concepts may be appropriate in some circumstances does not mean that we should import them where this will not further the policies of the Securities Act. *Geon Industries,* 531 F.2d at 54; *Management Dynamics,* 515 F.2d at 813. Second, the scope of the common law concepts themselves, at least at their outer perimeters, is sensitive to the basic legal policies relevant to the particular legal context. Of course, section 20(a) reflects *one* set of purposes underlying the Securities Act; and in an appropriate context (perhaps involving the use of 'dummies') it could become relevant to a definition of common law vicarious liability. Yet, none of this is here at issue. The facts and theories of this case place it in the heartland of traditional agency law; and we find in section 20(a) no basis for exemption.

For these reasons, the determination of the district court is

Affirmed.

APPENDIX B

UNITED STATES DISTRICT COURT

DISTRICT OF MASSACHUSETTS

Civil Action No. 83-4032-S

BENJAMIN SLOMOFF,

Plaintiff,

v.

MAURICE STRONG, *et al.*,

Defendants.

Civil Action No. 83-4031-S

BRUNO ROSSI,

Plaintiff,

v.

MAURICE STRONG, *et al.*,

Defendants.

Civil Action No. 83-4181-N

JAMES P. GIBLIN, *et al.*,

Plaintiffs,

v.

MAURICE STRONG, *et al.*,

Defendants.

Civil Action No. 84-405-N

MARGARET HALL FOUNDATION, INC., *et al.*,

Plaintiffs,

v.

MAURICE STRONG, *et al.*,

Defendants.

Appendix B

Civil Action No. 83-4033-MC

GERALD HOLTON, *et al.*,

Plaintiffs,

v.

MAURICE STRONG, *et al.*,

Defendants.

MEMORANDUM AND ORDER

July 31, 1984

SKINNER, D.J.

These five actions have been consolidated solely for the purpose of deciding the motions of certain defendants to dismiss. These motions raise issues common to all five cases. The complaints in all five cases are virtually identical. In brief, the plaintiffs allege that they entered into investment advisory agreements with Atlantic Financial Management, Inc. ("Atlantic"), and that principals of Atlantic sold their own AZL Resources, Inc. ("AZL") stock while they were manipulating its price and purchasing it for the plaintiffs. The defendants, whose motions I now consider, are AZL, Leonard C. Hentsch, Tom F. Marsh, Mel P. Melsheimer, Scott M. Spangler, Maurice Strong and Herman W. Vanloo. For the purposes of this memorandum only, I shall refer to these AZL related defendants as "the defendants".

The plaintiffs seek damages for violations of §10(b) of the Securities Exchange Act of 1934 ("the 1934 Act"), 15 U.S.C. §78a *et seq.*, and 17 C.F.R. §240.10b-5 ("10b-5"),

which was promulgated pursuant to §10(b). All of the plaintiffs except Giblin also state claims under §9(a) of the 1934 Act. The plaintiffs also claim that various defendants violated §1962 of the Racketeer Influenced and Corrupt Organization Act ("RICO"), 18 U.S.C. §1961 *et seq.*, and M.G.L. c. 231. In addition, the complaints include claims of tortious interference with contractual relations, misrepresentation, breach of fiduciary duty, breach of contract, and negligence.

I. *The §9(a) claim.*

The plaintiffs in these actions have recently amended their complaints to include an allegation that they did not discover the acts of the defendants until August, 1983. This amendment clearly makes the action timely under the one-year period of limitation established in 9(e) of the 1934 Act.

II. *The interaction of the §9 and §10(b) claims.*

The defendants argue that the plaintiffs are limited to their express remedy under §9 because otherwise the implied right of action under §10(b) would nullify the procedural requirements of §9. Most courts have rejected this argument. *See, e.g., Schaefer* v. *First National Bank of Lincolnwood,* 508 F.2d 1287, 1293 (7th Cir. 1975), *cert. denied,* 425 U.S. 943 (1976). The Supreme Court recently rejected a similar argument in *Herman & MacLean* v. *Huddleston,* 103 S.Ct. 683 (1983). In *Huddleston,* the Court held that the availability of an express remedy under §11 of the Securities Act of 1933 does not preclude defrauded

purchasers of registered securities from maintaining an action under §10(b) of the 1934 Act.

> A cumulative construction of the securities laws also furthers their broad remedial purposes. In enacting the 1934 Act, Congress stated that its purpose was "to impose requirements necessary to make [securities] regulation and control reasonably complete and effective". 15 U.S.C. §78b. In furtherance of that objective, Section 10(b) makes it unlawful to use "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security. The effectiveness of the broad proscription against fraud in Section 10(b) would be undermined if its scope were restricted by the existence of an express remedy under Section 11 (footnote omitted). Yet we have repeatedly recognized that securities laws combating fraud should be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes". *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180, 195, 84 S.Ct. 275, 284, 11 L.Ed. 2d 237 (1963). *Accord; Superintendent of Insurance* v. *Banker Life & Cas. Co.,* 404 U.S. 6, 12, 92 S.Ct. 165, 169, 30 L.Ed. 2d 128 (1971); *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 151, 92 S.Ct. 1456, 1471, 31 L.Ed.2d 741 (1972). We therefore reject an interpretation of the securities laws that displaces an action under Section 10(b) (footnote omitted). *Id.* at 689-690.

Moreover, the Court indicated that Congress had recently "ratified the cumulative nature of the Section 10(b) action". *Id.* at 689.

Although *Huddleston* did not deal explicitly with §9, I see no reason why the Court's analysis, which is phrased

broadly, should not govern §9 actions. Indeed, one court which had accepted the defendants' argument recently reversed itself in light of *Huddleston*. *See Chemetron* v. *Business Funds*, 682 F.2d 1149 (5th Cir. 1982), *vacated and remanded*, 103 S.Ct. 1245 (1983), 718 F.2d 725 (5th Cir. 1983), *rehearing granted* (1983).[1] Accordingly, I will follow the Supreme Court's decision in *Huddleston* and reject the defendant's argument.

III. *The plaintiffs' status as "purchasers".*

In order to have standing under Sections 9(a) and 10(b) of the 1934 Act, a party must be a "purchaser" or "seller" of securities. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). The defendants contend that the plaintiffs were not purchasers because they entrusted full discretionary authority over their accounts to Atlantic.

The defendants cite no cases which directly support the proposition that a person who entrusts his money to a manager cannot seek redress under the 1934 Act. They rely primarily upon a line of cases involving the standing of beneficiaries of a trust. *See, e.g., O'Brien* v. *Continental Illinois National Bank & Trust Co.*, 593 F.2d 54 (7th Cir. 1979).

I find the defendants' analogy unpersuasive. Courts have found that beneficiaries of a trust are purchasers within the meaning of the 1934 Act when they retain even a small degree of control over investment decisions. *See, e.g., Norris* v. *Wirtz*, 719 F.2d 256 (7th Cir. 1983). In this case, although the plaintiffs allege in their complaints that

1. As of the date of this order, the Court of Appeals has not yet heard oral argument again on this case.

Appendix B

Atlantic had full discretionary authority over their accounts, the plaintiffs always retained the option of terminating their agreement with Atlantic if they did not agree with individual investment decisions. Moreover, unlike cases involving beneficiaries, the plaintiffs actually possessed the purchased securities. The facts as pleaded are sufficient to support a claim that an agency relationship existed between the plaintiffs and their investment managers. *Cf. Huddleston, supra* at 690 (the Supreme Court has "repeatedly recognized that securities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes'.") (quoting *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180 (1963)). The plaintiffs' allegation that their agents relied upon the alleged misrepresentations of the defendants satisfies the requirement that they must plead reliance in their complaint in order to state a claim. Accordingly, I hold that the plaintiffs have standing to pursue their claims under the 1934 Act and that the complaint does not fail to state a claim for failure to include the element of reliance in its allegations.

IV. *The particularity of the pleaded facts.*

The defendants contend that the claims against Strong, all of the insider trading claims, and the claim against AZL should be dismissed pursuant to Fed.R.Civ.P. 9(b) for failure to plead fraud with particularity.

A. *The claim against Strong and the insider trading claims.*

The allegations against Strong are pleaded with considerable, even excessive, particularity. *See, e.g., Rossi Com-*

plaint ¶36 ("On September 21, 1981, at a meeting attended by Strong, DiIanni, Tuton and others at the Yale Club in New York City, Strong represented that AZL was then engaged in merger negotiations with a large company, identified by Strong only as 'Company X', a billion dollar company, listed on the New York Stock Exchange . . ."). Essentially, the defendants' argument is that this claim should be rejected because the plaintiffs have not provided documentation of their claims. *See, e.g.*, Individual Defendants' Memorandum at 37 ("All of plaintiffs' allegations . . . are made on information and belief without any *attribution of the source* of plaintiffs' information". (emphasis added) The defendants' argument is without merit, since the complaint states the time, place, and content of the alleged false representations. *See Wayne Investment, Inc.* v. *Gulf Oil Corporation*, No. 84-1099 (1st Cir. July 18, 1984). The particularity requirement of §9(b) does not require a party to plead evidence. *See McGinty* v. *Beranger Volkswagen, Inc.*, 633 F.2d 226, 228 (1st Cir. 1980).

The same analysis applies to the defendants' arguments concerning the inside trading claims. Contrary to the defendants' contention that "the material nonpublic information" is never specified, *see* Individual Defendants' Memorandum at 39, the nature of the inside information allegedly used by the defendants is laid out in the complaints. Accordingly, this argument also lacks merit.

B. *The claim against AZL.*

One of the cornerstones of corporate law is that a corporation is responsible for the acts and omissions of its agents, officers, and employees acting under the corporate

banner. *Holmes* v. *Bateson,* 583 F.2d 542, 561 (1st Cir. 1978). The plaintiffs acknowledge that in order for a corporation to be held liable as a principal for the fraud of one of its officers, a party must show both that the fraud occurred in the course of the officer's employment and for the benefit of the corporation. *Rochez Brothers* v. *Rhoades,* 527 F.2d 880, 884 (3d Cir. 1975). In this case, the plaintiffs have alleged facts which negate any inference that the actions of Strong and others were performed for the benefit of AZL.

In their memorandum, the plaintiffs suggest that "AZL stood to gain through its enhanced attractiveness as a merger candidate", even though in the same sentence they allege that Strong was personally advancing his own interests by selling "corporate shares at artificially high prices". Plaintiffs' Memorandum at 6. The complaint does not allege facts which could explain why this action, which should discourage buyers, would encourage a merger or takeover. The plaintiffs' memorandum provides no guidance to explain how AZL could conceivably have made itself more attractive to corporate suitors by driving up the price of its stock. In fact, there is no allegation of actual merger discussions. The only possible view of the facts as alleged is that the individual defendants were pursuing their own selfish ends. Accordingly, I dismiss all claims against AZL.

V. *The contemporaneous trading element of the insider trading claims.*

The defendants contend that the claim against Marsh in the *Margaret Hall* complaint should be dismissed because the only alleged insider trade occurred almost two weeks

after the last trade upon which the plaintiffs assert a claim. They also contend that the *Holton* complaint is too vague to permit a determination as to whether the plaintiffs traded contemporaneously with Marsh. With regard to the *Margaret Hall* complaint, the defendants mischaracterize the plaintiffs' complaint. The *Margaret Hall* complaint alleges that "Atlantic continued to invest heavily in AZL common stock" during November and December, 1981. *Margaret Hall* Complaint ¶49. The complaint also alleges that Marsh traded 30,000 shares of AZL stock on November 13, 1981. The defendants' argument is without merit.

The argument regarding the *Holton* complaint borders on the frivolous. Holton alleges that Atlantic bought AZL stock on Holton's behalf in every month from August, 1981 through February, 1982, except October. He also alleges that Marsh traded in AZL stock on November 13, 1981. These allegations are more than sufficient.

VI. *The RICO claim.*

The defendants contend the plaintiffs' RICO claims should be dismissed because the plaintiffs: (1) have not alleged sufficient predicate acts to constitute a pattern of racketeering activity; (2) have failed to allege injury distinct from the injury caused by the alleged predicate offenses; (3) lack standing due to the type of injury they have suffered; and (4) cannot establish a link between the defendants and organized crime. Furthermore, they contend that venue is improper in this district.

Section 1962 of RICO describes three types of prohibited activity: §1962(a) prohibits the use of any income "directly

or indirectly derived" from a "pattern of racketeering activity" to acquire an interest in a business. Section 1962(b) prohibits the direct use of a "pattern of racketeering activity" to acquire an interest in a business, and §1962(c) prohibits employees of an enterprise from conducting its affairs "through a pattern of racketeering activity". Section 1962(d) also makes a conspiracy to engage in any of these activities a violation of RICO. "Pattern of racketeering activity" is defined in §1961(5) as "at least two acts of racketeering activity within ten years". "Racketeering activity" is defined in §1961(1) as covering a broad range of acts, including "fraud in the sale of securities . . . punishable under any law of the United States". Any person injured by §1962 is granted a right to sue for treble damages by §1964(c).

The predicate acts upon which the plaintiffs rely are a series of alleged misrepresentations made to Atlantic and to the financial community at large. Since each of these acts alleged in the complaints is "an act in itself subject to criminal sanction", S.Rep. No. 617, 91st Cong., 1st Sess. 158 (1969), *quoted in United States* v. *DePalma*, 461 F.Supp. 778, 783 n.6 (S.D.N.Y. 1978), the plaintiffs' allegations are sufficient to support a motion to dismiss. *See, Spencer Companies, Inc.* v. *Agency Rent-A-Car, Inc.*, [1981-1982] CCH Fed.Sec.L.Rep. ¶98,361 at 92,214-5 (D. Mass. 1981).

The plaintiffs' problem is that the complaints do not allege that these defendants were using the pattern of racketeering activity for any of the purposes prohibited by §1962. They were using it to sell their stock at an inflated price. They were not acquiring an interest in an enterprise

(§1962(a) and (b)), nor conducting the affairs of an enterprise (§1962(c)) nor conspiring to do either of these things. The complaint does not allege that the activities of the individual defendants, although perhaps evidencing a conspiracy, themselves constituted an enterprise. *See United States* v. *Anderson*, 626 F.2d 1358, 1369 ff (8th Cir. 1980), *cert. denied* 450 U.S. 912; *United States* v. *Turkette*, 452 U.S. 576, 583 (1981). Accordingly, the RICO claims against these defendants must be dismissed.

VII. *Conclusion.*

The defendants' motion to dismiss is ALLOWED as to the claims against AZL and as to the RICO claims against all defendants. The motion is otherwise DENIED.

/s/ WALTER JAY SKINNER

United States District Judge

APPENDIX C

UNITED STATES DISTRICT COURT

DISTRICT OF MASSACHUSETTS

Civil Action No. 83-4032-S

BENJAMIN SLOMOFF,

Plaintiff,

v.

MAURICE STRONG, *et al.*,

Defendants.

Civil Action No. 83-4031-S

BRUNO ROSSI,

Plaintiff,

v.

MAURICE STRONG, *et al.*,

Defendants.

Civil Action No. 83-4181-N

JAMES P. GIBLIN, *et al.*,

Plaintiffs,

v.

MAURICE STRONG, *et al.*,

Defendants.

Civil Action No. 84-405-N

MARGARET HALL FOUNDATION, INC., *et al.*,

Plaintiffs,

v.

MAURICE STRONG, *et al.*,

Defendants.

Appendix C

Civil Action No. 83-4033-MC

GERALD HOLTON, *et al.*,

Plaintiffs,

v.

MAURICE STRONG, *et al.*,

Defendants.

MEMORANDUM AND ORDER

January 7, 1985

SKINNER, D.J.

These five plaintiffs, following my dismissal of certain of their claims on July 31, 1984, now move for leave to amend their complaints. The motions raise common issues and seek to insert virtually identical language in virtually identical complaints. Accordingly, the five actions are consolidated for the purpose of deciding these motions. The defendants are AZL Resources, Inc. ("AZL"), Leonard C. Hentsch, Tom F. Marsh, Mel P. Melsheimer, Scott M. Spangler, Maurice Strong, and Herbert Van Loo ("the defendants").

In their complaints, the plaintiffs sought to impute the alleged securities fraud of AZL's chairman, Maurice Strong ("Strong"), to AZL, on the basis that the fraud occurred in the course of Strong's employment and for the benefit of the corporation. I found that the allegations negated any inference that the actions of Strong were performed for the benefit of AZL. The plaintiffs also sought to hold

both AZL and the individual defendants liable for violation of § 1962(c) of the Racketeer Influenced and Corrupt Organization Act ("RICO"), 18 U.S.C. §§ 1961-1968, but I found that the complaints failed to allege that the activities of the individual defendants constituted an "enterprise" as required by RICO. Accordingly, I dismissed both sets of claims.

Amendment of Securities Fraud Claim against AZL.

According to the complaints, between April 1981 and February 1982, Strong induced the plaintiffs' investment advisors to invest heavily in AZL common stock by representing that he was negotiating an imminent merger or acquisition, as well as a large block sale of AZL stock, that would provide the corporation with capital to develop promising oil and gas rights. These representations, they allege, were "fraudulent and/or misleading", and comprised a scheme in violation of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 to inflate, and that did inflate, the market price of AZL common stock. AZL, the plaintiffs correctly have argued, may be held directly liable for Strong's misrepresentations to the extent that he acted in the course of his employment and for AZL's benefit. *Holmes* v. *Bateson,* 583 F.2d 542, 561 (1st Cir. 1978); *Rochez Bros.* v. *Rhoades,* 527 F.2d 880, 884 (3rd Cir. 1975).

The original complaints adequately alleged that Strong acted in the course of his employment. To correct the failure to allege a benefit to AZL, the plaintiffs now assert that an inflated market price for AZL common stock would assure a greater exchange ratio in a stock-for-stock merger

or acquisition and more cash from a sale or pledge of treasury stock, or a new issue.

AZL could have benefited in the manner postulated only if some discussions leading toward a merger or stock sale actually took place. Yet nowhere in the original complaints or in the amendments offered do the plaintiffs plead that such discussions occurred. Instead, one only finds copious assertions that Strong represented it to be so, and these representations are precisely the statements alleged to have been fraudulent. The plaintiffs cannot assert on the one hand that Strong's representations were false or misleading and imply on the other that he spoke the truth without entering into an inconsistency that is fatal to their claim.

The proposed amendments assert another theory of recovery against AZL that does not require the allegation of benefit to AZL. The plaintiffs explicitly allege that Strong acted with "at least apparent authority" in disseminating the reports of an imminent merger and stock sale.

Under general agency principles, a corporation is liable for the fraud of its agent committed with apparent authority even if the agent's conduct was effected for his benefit alone. *Kerbs* v. *Fall River Industries, Inc.*, 502 F.2d 731, 740-741 (10th Cir. 1974). *New England Acceptance Corp.* v. *American Mfrs. Mutual Ins. Co.*, 4 Mass. App. 172, 344 N.E.2d 208, 214 (1976), *aff'd*, 373 Mass. 544, 368 N.E.2d 1385, 1387 (1977). *Restatement (Second) of Agency*, §§ 261-262 (1957) ("Restatement"). *See Rochez Brothers* v. *Rhoades, supra. See also, American Society of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. 556, 568 (1982). The corporation bears the risk of loss, since the party injured through dealing with the corporate agent

ordinarily cannot ascertain whether the agent is acting in fact for the benefit of the corporate principal. *Restatement,* § 262 Comment a. The corporation can avoid liability by showing that the injured party had notice of the agent's self-interest. *Id.* § 262. General agency principles have been applied in this circuit to the determination of direct liability of a corporation under § 10(b) of the Securities Exchange Act. *Holmes* v. *Bateson,* 583 F.2d 542 (1st Cir. 1978).

Under this theory, it would be of no consequence whether merger or stock sale negotiations ever took place, or that Strong might have been acting strictly in self-interest or to benefit persons other than the corporation. *Restatement,* § 262. AZL's liability for Strong's fraud would be established by proof that Strong appeared to be acting within the scope of his authority when he disseminated allegedly false or material information, and that AZL had put him in a position to commit this fraud upon the plaintiffs. At this stage, the allegations that Strong was AZL's chairman, a position customarily allowing the officeholder to speak for and negotiate on behalf of the corporation, and that ostensibly he was pursuing the corporate goal of raising capital, sufficiently support the assertion that Strong acted with apparent authority. *Kerbs* v. *Fall River Industries, Inc.,* 502 F.2d at 741.

Accordingly, leave to amend under Fed.R.Civ.P. 15(a) will be granted, but only as to the allegation of apparent authority. Upon the prompt filing of such an amendment, the securities fraud claims against AZL dismissed previously shall be reinstated, and AZL shall answer thereto within ten days after the amended complaint is filed.

Appendix C

Revival of RICO Claims.

On July 31, 1984, I dismissed all claims under RICO on the grounds that the plaintiffs had failed to state a violation of § 1962 of the act. In particular, though they alleged that AZL, Strong, Sogener, Hentsch and VanLoo (the "RICO defendants")[1] had conducted the affairs of an enterprise through a pattern of racketeering activity—at least two acts of criminally sanctioned "fraud in the sale of securities", § 1961(1)—they failed to identify the "enterprise" with which the RICO defendants were associated. *See* § 1962(c).[2] They now identify three "enterprises": (1) AZL; (2) an association, comprised of Strong, AZL, Societe Generale pour l'Energie et Les Ressources and Credit Immobilier S.A. who allegedly violated §§ 9(a) and 10(b) of the Securities Exchange Act; and (3) an association, comprised of the individual defendants, Sogener and CI, who as stockholders of AZL allegedly engaged in insider trading.

Even with this amendment, however, the RICO claims remain defective for several reasons. First, "RICO quite clearly envisions a relationship between a 'person' [the defendant conducting the affairs of an enterprise through a pattern of racketeering activity] and an 'enterprise' as an element of an offense." *Van Schaick* v. *Church of Sci-*

1. Plaintiff Giblin omitted AZL as a RICO defendant.

2. Section 1962(c) reads:

> It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

entology of Cal., Inc., 535 F.Supp. 1125, 1135-1136 (D. Mass. 1982). *Cf. U.S.* v. *Hartley*, 678 F.2d 961, 988 (11th Cir. 1982) (criminal defendant can be "enterprise"). But AZL is named a defendant here, i.e., a "person" who allegedly has violated § 1962(c). According to this new allegation, however, AZL is an "enterprise" as well. Given these allegations, it is clear that the required relationship cannot exist.

Second, more than a bare invocation of the term "enterprise" connected with the names of a group of persons is required to satisfy the pleading requirements of a RICO claim. The Supreme Court in *U.S.* v. *Turkette*, 452 U.S. 576 (1981), has laid out the elements constituting a RICO "enterprise" that must be alleged and proved: that the various associates function (1) as a "continuing unit" (2) for a common purpose, and (3) that the enterprise has an existence "separate and apart from the pattern of activity in which it engages". *Id.* at 583; *U.S.* v. *Riccobene*, 709 F.2d 214, 222-224 (3rd Cir. 1983), *cert. denied*, 104 S.Ct. 157; *Seville Indus. Machinery Corp.* v. *Southmost Machinery Corp.*, 567 F.Supp. 1146, 1150-1153 (D. N.J. 1983). The complaints as amended would be devoid of such allegations.

Third, the private remedy under RICO extends only to those "injured in [their] business or property by reason of a violation of section 1962". 18 U.S.C. § 1964(c). The plaintiffs allege that "[a]s a result of defendants' RICO violations, [they] have suffered serious financial loss". The plaintiffs must spell out how they have been injured by the § 1962 violation, so that the court can ascertain that

they are not merely recasting their securities fraud claims as RICO claims to take advantage of the treble damages remedy afforded by RICO. *Van Schaick* v. *Church of Scientology of Cal., Inc.*, 535 F.Supp. 1125, 1138 (D. Mass. 1982); Bridges, "Private RICO Litigation Based Upon 'Fraud in the Sale of Securities' ", 18 Ga.L.Rev. 43, 67-72 (1983). *See Spencer Companies, Inc.* v. *Agency Rent-A-Car, Inc.*, [1981-1982] Fed.Sec.L.Rep. (CCH) ¶ 98,361 at 92,216 (D. Mass. 1981).

Accordingly, because the RICO claims as amended will be subject to dismissal for the foregoing deficiencies, it is futile to grant leave to add them. *Jackson* v. *Salon*, 614 F.2d 15, 17 (1st Cir. 1980).

Conclusion.

The plaintiffs' motion for leave to amend is ALLOWED as to the allegation that Strong acted with apparent authority of AZL, and is otherwise DENIED.

/s/ WALTER JAY SKINNER

United States District Judge

APPENDIX D

UNITED STATES DISTRICT COURT

DISTRICT OF MASSACHUSETTS

MDL Docket No. 584

IN RE:

ATLANTIC FINANCIAL MANAGEMENT, INC.
SECURITIES LITIGATION

Civil Action No. 83-4032-S

BENJAMIN SLOMOFF,

Plaintiff,

v.

MAURICE STRONG, *et al.*,

Defendants.

Civil Action No. 83-4031-S

BRUNO ROSSI,

Plaintiff,

v.

MAURICE STRONG, *et al.*,

Defendants.

Civil Action No. 83-4181-N

JAMES P. GIBLIN, *et al.*,

Plaintiffs,

v.

MAURICE STRONG, *et al.*,

Defendants.

Appendix D

Civil Action No. 84-405-N

MARGARET HALL FOUNDATION, INC., *et al.*,
Plaintiffs,

v.

MAURICE STRONG, *et al.*,
Defendants.

Civil Action No. 83-4033-MC

GERALD J. HOLTON, *et al.*,
Plaintiffs,

v.

MAURICE STRONG, *et al.*,
Defendants.

Civil Action No. 84-3033-S

MICHAEL HOLT MASSEY,
Plaintiff,

v.

MAURICE STRONG, *et al.*,
Defendants.

MEMORANDUM AND ORDER ON DEFENDANT AZL'S MOTIONS FOR RECONSIDERATION

February 15, 1985

SKINNER, D.J.

AZL Resources, Inc. ("AZL") moves for reconsideration of a memorandum and order dated January 7, 1985,

allowing the plaintiffs in the actions captioned above to amend their complaints under Fed.R.Civ.P. 15(a). The amendment made AZL a defendant once again in this litigation on the basis of an allegation that AZL's chairman Maurice Strong, acted with the apparent authority of the corporation in committing securities fraud. AZL moves similarly for reconsideration of the memorandum and order dated January 10, 1985, in *Michael Holt Massey* v. *Maurice Strong, et al.*, C.A.No. 84-3033-S, denying AZL's motion to dismiss Count I of Massey's complaint, which contains a similar allegation. Because these motions raise identical issues, I consolidate them, for purposes of this review only.

As grounds for reconsideration, AZL claims that this theory was not briefed or argued to the court; that this theory is based on *respondeat* superior, which is inapplicable in securities fraud cases; and that even if applicable, *respondeat superior* is not supported by the facts alleged.

Upon careful consideration, I find that none of these grounds mandates vacating the January 7, 1985 order allowing the limited amendment. First, the plaintiffs' proposed amendment showed the allegation of apparent authority on its face. AZL as well as the court had the opportunity to note and address the sufficiency of the claim. Leave to amend was granted under Fed.R.Civ.P. 15(a), the controlling principle of which is a liberal discretion to be exercised "when justice so requires". AZL has not shown nor does it appear that it is prejudiced at this early stage of the litigation by the modest shift in the focus of the plaintiffs' claims entailed in the amendment. *Cf.* 5 Wright & Miller, *Fed.Prac. and Proc.* § 1219 pp. 144-146 (1969).

Second, the January 7, 1985 order found the plaintiffs' allegation of Strong's apparent authority legally sufficient on the basis of a corporate principal's direct liability for the binding acts of its agents, not *respondeat superior.*

Last, AZL argues that the facts alleged show Strong leaking "inside" information to Atlantic Financial Management to induce open market purchases of AZL stock, conduct in patent violation of securities laws and therefore legally inadequate to evidence apparent authority binding the corporation. As I read the allegations of the complaint, the plaintiffs seek redress because Strong transmitted false and misleading, not "inside", information. Furthermore, they allege that he did so not only in private to the principals of Atlantic but also in public through press releases issued by AZL itself and public meetings with investors and investment advisors. The complaint as amended shows Strong, in his role as AZL's chairman, making representations about the company the truthfulness of which is in question. Nothing in that scenario is inconsistent with the theory of liability on which AZL is once again a defendant in these related actions.

Accordingly, the motion of AZL Resources, Inc. for reconsideration of the court's order of January 7, 1985 is DENIED. No costs or attorneys fees to plaintiffs.

/s/ WALTER JAY SKINNER

United States District Judge

APPENDIX E

UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF MASSACHUSETTS

MDL Docket No. 584

Civil No. 83-4032-S
Civil No. 83-4031-S
Civil No. 83-4181-N
Civil No. 84-0405-N
Civil No. 83-4033-MC
Civil No. 84-3033-S

IN RE:

ATLANTIC FINANCIAL MANAGEMENT, INC.
SECURITIES LITIGATION.

DEFENDANT AZL RESOURCES, INC.'S REQUEST FOR CERTIFICATION UNDER 28 U.S.C. Sec. 1292(b)

Allowed. I certify that my order of February 15, 1985 involves a controlling question of law, that there is by a split in the circuits, and that a reversal will terminate the litigation as to AZL.

5/13/85 /s/ W. J. SKINNER, U.S.D.J.

APPENDIX F

UNITED STATES COURT OF APPEALS

FOR THE FIRST CIRCUIT

Misc. No. 85-8023

IN RE:

ATLANTIC FINANCIAL MANAGEMENT, INC.,
SECURITIES LITIGATION,

Petitioners.

ORDER OF COURT

Entered June 12, 1985

The petition for leave to appeal is granted.

By the Court,

FRANCIS P. SCIGLIANO
Clerk.

[Cert. cc: Clerk, U.S.D.C. of Mass.; cc: Messrs. Sayers and Hellerstein]

Supreme Court, U.S.
FILED
JUN 20 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-1877.

In the Supreme Court of the United States.

OCTOBER TERM, 1985.

AZL RESOURCES, INC.,
PETITIONER,

v.

MARGARET HALL FOUNDATION, INC., ET AL.,
RESPONDENTS.

Brief in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the First Circuit.

PETER J. SCHNEIDER,
Counsel of Record
LAWRENCE G. CETRULO,
BURNS & LEVINSON,
50 Milk Street,
Boston, Massachusetts 02109.
(617) 451-3300

Of Counsel:
SAMUEL ADAMS,
WARNER & STACKPOLE,
28 State Street,
Boston, Massachusetts 02109.
(617) 725-1400

BATEMAN & SLADE, INC. BOSTON, MASSACHUSETTS

27pp

Question Presented.

Whether Section 20(a) of the Securities Exchange Act of 1934 precludes the assertion of liability, based on common law principles of apparent authority, against a corporation for the misrepresentations of an important corporate officer.

List of Parties.

The list of parties is as stated by the petitioner.

Rule 28.1 List.

Margaret Hall Foundation, Inc. and Lexington Cemetery Co., Inc. have no parent companies, subsidiaries or affiliates. The Plymouth-Home National Bank is a subsidiary of Conifer Group, Inc. The following companies are also subsidiaries of Conifer Group, Inc.: Bank of Cape Cod, Berkshire Bank & Trust Company, Essex Bank, Guaranty Bank & Trust Company, Conifer Computer Services, Inc. and Union National Bank.

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No. 85-1877.

In the Supreme Court of the United States.

OCTOBER TERM, 1985.

AZL RESOURCES, INC.,
PETITIONER,

v.

MARGARET HALL FOUNDATION, INC., ET AL.,
RESPONDENTS.

Brief in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the First Circuit.

The respondents[1] respectfully request that the petition for a writ of certiorari to review the judgment and opinion of the

[1] The respondents, plaintiffs in six of twenty four actions consolidated in the District of Massachusetts by the Judicial Panel on Multidistrict Litigation under MDL Docket No. 584, are Margaret Hall Foundation, Inc., Lexington Cemetery Co., Inc., Harley Anderson Haynes, Ruth Mann Horowitz, Robert L. Horowitz as Trustee of the Alan J. Mann Trust, Susan P. Mann Trust and Gail A. Mann Trust, Walter B. Gates, George M. Berman and Alan R. Shoolman (as they comprise the Profit-Sharing Committee of the Unitrode Profit-Sharing Plan and Profit Sharing Trust Fund), and Martin B. Hoffman (as Trustee of Landlubber Deferred Profit Sharing Retirement Plan), individually and on behalf of ail others similarly situated; Benjamin Slomoff; Gerald J. Holton, Individually and as Employer and as Beneficiary of His Self-Employed

United States Court of Appeals for the First Circuit, entered in this proceeding on February 19, 1986, be denied.

Opinions Below.

The opinions below are as stated by the petitioner.

Jurisdiction.

AZL's statement of jurisdiction is correct, except insofar as it states that on May 13, 1985 "the District Court of Massachusetts certified the issue herein for review." Petition for a Writ of Certiorari to the United States Court of Appeals for the First Circuit ("Pet.") 2. As set forth below in respondents' statement of the case, the question presented by AZL differs markedly from the issue addressed by the District of Massachusetts' February 15, 1985 order and from the issue decided by the Court of Appeals for the First Circuit.

Statutes Involved.

15 U.S.C. § 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate com-

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Retirement Plan and Plymouth-Home National Bank as Trustee of a Self-Employed Retirement Plan, Gerald J. Holton FBO Gerald J. Holton; Bruno Rossi; James P. Giblin individually, and James P. Giblin as Trustee of the James P. Giblin Trust; and Michael Holt Massey. The six actions were the subject of the February 15, 1985 District of Massachusetts decision from which petitioner appealed to the Court of Appeals for the First Circuit, pursuant to 28 U.S.C. § 1292(b).

merce or of the mails or of any facility of any national securities exchange:

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 77b. Definitions

When used in this subchapter, unless the context otherwise requires:

. . . . . .

(2) The term "person" means an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or government or political subdivision thereof. As used in this paragraph the term "trust" shall include only a trust where the interest or interests of the beneficiary or beneficiaries are evidenced by a security.

15 U.S.C. § 78t. Liability of controlling persons

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Statement of the Case.

Plaintiffs' amended complaints allege that Maurice Strong ("Strong"), the chairman of AZL Resources, Inc. ("AZL"), acting with at least the apparent authority of AZL, engaged in a scheme to disseminate materially false and/or misleading information involving AZL and an impending block purchase of AZL stock in order to manipulate the market price of AZL common stock by artificially inflating its price. Supplemental Appendix ("Supp. App."). The amended complaints followed an opinion dated July 31, 1984, in which the District Court of Massachusetts ("District Court") dismissed plaintiffs' claims against AZL because it found that the facts as alleged in the original complaints negated any inference that the actions of Strong and the other corporate officers and agents were performed for AZL's benefit, a necessary predicate for *respondeat superior* liability.[2] Appendix ("App.") B, 23a. Thereafter, on January 7, 1985, the District Court allowed plaintiffs' motions to amend to allege that Strong acted with "at least apparent authority" — a theory of liability which does not require a showing of benefit to AZL. App. C, 30a-31a.

AZL moved for reconsideration of the January 7, 1985 order, arguing in essence that the theory of liability asserted against AZL was based on *respondeat superior,* which, in AZL's view, had no applicability to securities fraud cases. App. D, 37a. In denying AZL's motion for reconsideration on February

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[2] As the plaintiffs have consistently argued below, the facts alleged by their complaints, and the inferences to be drawn therefrom, are adequate to support a finding that AZL stood to benefit from the misrepresentations of Maurice Strong and other AZL officers and directors, and from the subsequent artificial inflation of AZL's stock price. AZL stood to benefit from the higher stock price by obtaining an increased exchange ratio in any subsequent merger and by more readily obtaining capital, absent a merger, to fund its oil exploration activities.

15, 1985, the District Court held that the allegations of AZL's liability were legally sufficient based on a corporate principal's direct liability for the acts of its agents, not *respondeat superior*. App. D, 38a.

The District Court subsequently allowed AZL's request for certification of the issue determined by the District Court's February 15, 1985 order. App. E, 39a. In an opinion dated February 19, 1986, the First Circuit held that "section 20(a) [of the Securities Exchange Act of 1934] does not preclude the assertion of liability — based on common law notions of 'apparent authority' — against a corporation for the misrepresentations of an important corporate officer." App. A, 15a. It is this decision that petitioner now seeks to have this Court review.[3]

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[3] AZL framed the question presented here for review, Pet. I, in a manner which is at variance with the First Circuit's narrow holding that "section 20(a) does not preclude the assertion of liability — based on common law notions of 'apparent authority' — against a corporation for the misrepresentations of an important corporate officer." App. A, 15a. The First Circuit made no attempt to decide the general applicability of "principles of vicarious and strict liability" — a far broader question than the narrow issue of the applicability of agency-based liability premised on apparent authority addressed by the First Circuit. *Id.*

AZL's statement of the case, Pet. 3-4, also contains inaccuracies. Contrary to AZL's assertions, Pet. 4, the issue decided by the First Circuit does not "arise in the context of" a conflict between *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) and *American Society of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. 556 (1982). Although the First Circuit does advert briefly to the relationship between those two cases, App. A. 5a-6a, it is not a focal point of the decision, primarily because, as discussed at Part II.B., *infra*, there is no conflict or inherent inconsistency between *Hochfelder* and *Hydrolevel*. Further, as discussed at Part II.C., *infra*, there is no sharp conflict between the circuits as to the issue decided by the First Circuit.

Summary of the Argument.

This case presents no extraordinary circumstances warranting interlocutory review by this Court, which has consistently refused to review cases concerning the applicability of common law agency principles to securities laws violations. In holding that Section 20(a) ("Section 20(a)") of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. (the "1934 Act") does not preclude the imposition of liability upon AZL for the misrepresentations of its chairman acting with its apparent authority, the First Circuit decision comports with traditional agency law principles, the remedial purposes and legislative history of the 1934 Act, and the decisions of the clear majority of circuits which have considered the issue. The First Circuit's decision does not vitiate the scienter requirement of Section 10(b) of the 1934 Act ("Section 10(b)") because the scienter of AZL's chairman, acting with apparent authority, is imputed to AZL.

Reasons for Denying the Writ.

I. The Court's Exceptional Power to Review An Appeal From An Interlocutory Order Should Not Be Exercised In This Case.

Rule 17 of the Rules of the Supreme Court of the United States provides, *inter alia,* that:

> A review on writ of certiorari is not a matter of right, but of judicial discretion, and will be granted only when there are special and important reasons therefor.

Moreover, as to interlocutory matters, this Court has long applied an even more stringent standard for the grant of review, holding that "except in extraordinary cases, the writ is not issued until final decree," *Hamilton-Brown Shoe Co.* v. *Wolf Brothers & Co.*, 240 U.S. 251, 258 (1916), and that a writ of certiorari at an interlocutory stage of a case should not be issued unless extraordinary inconvenience and embarrassment in the conduct of a case will result from its denial. *American Constr. Co.* v. *Jacksonville, T.&K. W. Ry. Co.*, 148 U.S. 372, 384 (1893).[4]

No extraordinary circumstances are present here. First, AZL will not suffer, nor can it plead, extraordinary inconvenience by the denial of its petition. AZL is no different from any other interlocutory petitioner which must bear whatever inherent inconveniences litigation entails. Moreover, even if AZL were not a party, it would still be extensively and centrally involved in discovery and trial proceedings as plaintiffs pursue their claims against Strong and the five other individual AZL officers and directors. Thus, AZL's presence as a party, by itself, does not amount to "extraordinary inconvenience." *See American Constr. Co., supra,* at 384. Additionally, because the First Circuit's decision falls squarely within the clear majority of circuits, as discussed at Part II.C., *infra,* no embarrassment will occur by the denial of AZL's interlocutory petition. Finally, by allowing the case to proceed to a final disposition below, AZL will have the opportunity to prove at trial that Strong was not acting within his apparent authority or that the plaintiffs could not reasonably have relied on any such apparent author-

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[4] In *American Constr. Co.* the petitioner sought review of a nonfinal judgment, arguing, among other grounds, that because one of the judges who took part in the decision was forbidden by law to sit at the hearing, the disputed decree was wholly void. To delay appeal until a final judgment was rendered in that case was clearly an extraordinary waste of judicial and legal resources and this Court, finding that the case satisfied the extraordinary circumstances test, accordingly granted certiorari.

ity, thereby escaping liability under applicable agency principles, and rendering unnecessary any review by this Court of the issue presented by AZL.

II. This Court Should Not Exercise Its Discretion to Grant AZL's Petition for a Writ of Certiorari Because AZL Has Failed to Present Any Special Or Important Reasons To Do So.

Since 1975 this Court has consistently declined to review cases concerning the applicability of common law agency principles to securities laws violations. *See, e.g., Sharp* v. *Coopers & Lybrand,* 649 F.2d 175 (3d Cir. 1981), *cert. denied,* 455 U.S. 938 (1982); *Henricksen* v. *Henricksen,* 640 F.2d 880 (7th Cir.), *cert. denied,* 454 U.S. 1097 (1981); *Marbury Management, Inc.* v. *Kohn,* 629 F.2d 705 (2d Cir.), *cert. denied,* 449 U.S. 1011 (1980); *Carpenter* v. *Harris, Upham & Co.,* 594 F.2d 388 (4th Cir.), *cert. denied,* 444 U.S. 868 (1979); *Zweig* v. *Hearst Corp.,* 521 F.2d 1129 (9th Cir.), *cert. denied,* 423 U.S. 1025 (1975). As demonstrated below, there is nothing in this case of such "peculiar gravity and general importance", *Hamilton-Brown Shoe Co., supra* at 258, to warrant this Court's departure from its prior practice.

A. *The First Circuit Correctly Ruled that AZL is Liable for Its Agents' Misrepresentations Made with the Apparent Authority of AZL.*

The First Circuit's decision is well within the ambit of traditional agency law in holding that AZL is liable under the 1934 Act for the misrepresentations of its chairman. Recognizing the remedial purposes of the 1934 Act, the First Circuit reasoned:

> [A]s between the corporation that has placed the official in a position to invoke its authority (though improperly) and a victim, it seems fairer that the former bear the burden of an uncompensated loss. Further, imposing such liability will encourage corporate officials to prevent unauthorized (but 'apparently authorized') misrepresentations, thereby helping to achieve an important Securities [Exchange] Act purpose.

App. A, 8a-9a.

After concluding that imposition of vicarious liability upon a corporation for the "apparently authorized" misrepresentations of a high corporate officer is consistent with the policies and purposes of the 1934 Act, the First Circuit examined whether the inclusion of Section 20(a) was intended to preclude the imposition of vicarious liability. The First Circuit aligned itself with the majority of other circuits which have found nothing in the legislative history of Section 20(a) to indicate that it was intended to be the exclusive basis for imposing liability on one "who, directly or indirectly, controls any person liable." App. A, 9a-12a, *see also* Part II.C., *infra*. Instead, the First Circuit concluded that the legislative history of Section 20(a) "makes clear that the section was aimed at expanding liability, rather than contracting it," App. A, 9a, and stated that "by explicitly including corporations in its definition of 'person', 15 U.S.C. § 77(b)(2), the statute seems to foresee that corporations will be held liable." App. A, 12a.

Because, as the First Circuit recognized, corporations can act only through their agents, this liability can only be imposed through principles of vicarious liability. Further, the facts and theories of this case place it "in the heartland of traditional agency law." App. A, 15a. Thus, it would do violence to the

statutory framework to hold that principles of vicarious liability do not apply and Section 20(a) is the exclusive basis for imposing secondary liability under the 1934 Act.

The First Circuit's decision below is fully consistent with this Court's holding in *American Society of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. 556, 570 (1982), a case arising under the Sherman Act, 15 U.S.C. §§ 1 et seq., that "a principal is liable for an agent's fraud though the agent acts solely to benefit himself, if the agent acts with apparent authority." *Id.* at 566. This Court recognized that the "apparent authority theory has long been the settled rule in the federal system" and that liability has been imposed upon principals based upon this theory in "a wide variety of areas." *Id.* at 567-568. In so holding this Court cited with approval two federal securities laws cases which adhere to the majority view that common law agency principles are available to impose liability for violation of the securities laws. *See Holloway* v. *Howerdd*, 536 F.2d 690 (6th Cir. 1976); *Kerbs* v. *Fall River Industries, Inc.*, 502 F.2d 731 (10th Cir. 1974).

B. *The Scienter Requirement of Section 10(b) is Not Vitiated by the First Circuit's Holding.*

Faced with this Court's affirmation of the vitality of the common law agency principle of apparent authority in *Hydrolevel*, AZL incorrectly contends that imposition of liability based on apparent authority in this case would be inconsistent with this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (holding that scienter is a necessary element of violations of Section 10(b) as implemented by Rule 10b-5). Pet. 4. The First Circuit recognizes *Hochfelder*'s scienter requirement, but correctly observes that the scienter requirement — with respect to a corporation which employs those who

knowingly or recklessly make misrepresentations — can be satisfied by the scienter of the agent. App. A, 5a-6a.

This Court has recognized that it is "elementary" that "impersonal entities can be guilty of 'knowing' or 'willful' violations of regulatory statutes through the doctrine of *respondeat superior*." *United States* v. *A & P Trucking Co.*, 358 U.S. 121, 125 (1958). The application of agency principles does not undermine the elements of liability necessary to establish a violation, but instead serves to identify those who may be held vicariously liable for that violation. The scienter requirement of Section 10(b) is satisfied by the state of mind or conduct of the agent, which may then, on appropriate facts, be imputed to the corporation. Here, Strong's willful and knowing violations of the 1934 Act must be imputed to AZL which cloaked Strong, its chairman, with at least apparent authority.

C. *Contrary to AZL's Assertions, No Sharp Conflict Exists Between the Circuits.*

In Argument V. of its Petition (Pet. 18-21), AZL asserts the existence of a "sharp conflict" between the circuits as to the applicability of common law agency principles to impose liability upon a principal for the securities fraud of its agent. AZL's assertion is inaccurate. By its decision below, the First Circuit became the tenth circuit to address, and the seventh to affirm, the applicability of common law agency principles to violations of the securities laws. It joined the clear majority of six other circuits — the Second,[5]

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[5] *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied* 449 U.S. 1011 (1980); *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801, 812-813 (2d Cir. 1975).

Fourth,[6] Fifth,[7] Sixth,[8] Seventh[9] and Tenth[10] Circuits — which have expressly found those agency principles applicable. Only three[11] of the ten circuits appear to take a contrary view — the Third, Eighth and Ninth — and, as the First Circuit noted with respect to the Ninth and Third Circuits, the persuasive force of the opinions of those circuits is limited by the fact that those cases involved factual circumstances wherein traditional agency principles prohibit or caution against liability. App. A, 13a. Accordingly, there is no sharp conflict between the circuits which would warrant this Court's review.

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[6] *Carras* v. *Burns*, 516 F.2d 251, 259, 261 (4th Cir. 1975); *Johns Hopkins University* v. *Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974).

[7] *Paul F. Newton & Co.* v. *Texas Commerce Bank*, 630 F.2d 1111, 1118-1119 (5th Cir. 1980); *Lewis* v. *Walston & Co., Inc.*, 487 F.2d 617, 623 (5th Cir. 1973).

[8] *Holloway* v. *Howerdd*, 536 F.2d 690, 694-695 (6th Cir. 1976); *Armstrong, Jones & Co.* v. *SEC*, 421 F.2d 359, 362 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970).

[9] *Fey* v. *Walston & Co., Inc.*, 493 F.2d 1036 (7th Cir. 1974); *Carroll* v. *First National Bank of Lincolnwood*, 413 F.2d 353, 358 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970).

[10] *Kerbs* v. *Fall River Industries, Inc.*, 502 F.2d 731 (10th Cir. 1974).

[11] *See, e.g., Sharp* v. *Coopers & Lybrand*, 649 F.2d 175, 180-184 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Rochez Bros.* v. *Rhoades*, 527 F.2d 880 (3d Cir. 1975); *Thomas* v. *Duralite Co., Inc.*, 524 F.2d 577 (3d Cir. 1975); *Myzel* v. *Fields*, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Christoffel* v. *E.F. Hutton & Co.*, 588 F.2d 665 (9th Cir. 1978); *Zweig* v. *Hearst Corporation*, 521 F.2d 1129, 1132-1133 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); *Kamen & Co.* v. *Paul Aschkar & Co.*, 382 F.2d 689 (9th Cir. 1967), *cert. granted*, 390 U.S. 942, *cert. dismissed*, 393 U.S. 801 (1968).

Conclusion.

For these reasons, a writ of certiorari should not issue to review the judgment and opinion of the United States Court of Appeals for the First Circuit.

Respectfully submitted,

PETER J. SCHNEIDER,
Counsel of Record
LAWRENCE G. CETRULO,
BURNS & LEVINSON,
50 Milk Street,
Boston, Massachusetts 02109.
(617) 451-3300

Of Counsel:

SAMUEL ADAMS,
WARNER & STACKPOLE,
28 State Street,
Boston, Massachusetts 02109.
(617) 725-1400

Supplemental Appendix.

IN RE:	)	
ATLANTIC FINANCIAL	)	
MANAGEMENT, INC.	)	MDL DOCKET NO. 584
SECURITIES LITIGATION	)	
	)	
MARGARET HALL	)	
FOUNDATION, INC., ET AL,	)	
Plaintiffs	)	CIVIL ACTION NO.
	)	83-405-S
V.	)	
MAURICE STRONG, ET AL,	)	
Defendants	)	
	)	

PLAINTIFFS' AMENDMENT TO THEIR COMPLAINT PURSUANT TO RULES 15 and 59 OF THE FEDERAL RULES OF CIVIL PROCEDURE

Plaintiffs hereby amend their Complaint by repeating and realleging each and every allegation of Paragraphs 1-117, inclusive, and by adding:

(1) as Paragraphs 30a and 30b, to be inserted immediately after Paragraph 30 and immediately preceding Paragraph 31, the following:

30a. During the period commencing at least as early as April 1981 through at least March 1982, AZL was actively seeking infusions of additional capital to finance the exploitation and development of oil and

gas properties in which it held an interest. The scheme and plan was calculated to assist AZL to obtain the level of capital it needed because, by increasing the market price of AZL stock, AZL (i) increased its ability to obtain a favorable exchange ratio in any stock-for-stock merger or acquisition through which AZL would acquire a company possessing the requisite capital and/or (ii) increased the amount of capital which AZL could raise directly by selling or pledging its stock.

30b. In disseminating the materially false and/or misleading information referred to in paragraph 30 Strong acted with at least the apparent authority of AZL.

Plaintiffs by their attorney,

/s/

Lawrence G. Cetrulo
BURNS & LEVINSON
50 Milk Street
Boston, MA 02109
(617) 451-3300

No. 85-1877

Supreme Court, U.S.
FILED
JUL 8 1986
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

October Term, 1985

AZL RESOURCES, INC.,

Petitioner,

v.

MARGARET HALL FOUNDATION, INC., *et al.*,

Respondents.

PETITIONER'S REPLY MEMORANDUM

ALVIN K. HELLERSTEIN
(Counsel of Record)
THOMAS FARBER
STROOCK & STROOCK & LAVAN
7 Hanover Square
New York, New York 10004
(212) 806-5400

and

JEROME GOTKIN
GORDON P. KATZ
WIDETT, SLATER & GOLDMAN, P.C.
60 State Street
Boston, Massachusetts 02109
(617) 227-7200

No. 85-1877

IN THE

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October Term, 1985

AZL Resources, Inc.,

Petitioner,

v.

Margaret Hall Foundation, Inc., *et al.*,

Respondents.

PETITIONER'S REPLY MEMORANDUM

Petitioner, AZL Resources, Inc. ("AZL"), respectfully submits this Reply Brief to address respondents' contention that this Court, having declined several years earlier to review cases involving the applicability of common law agency principles to the securities laws, should decline review here. This case is significantly different from the prior cases. Review is particularly appropriate for three reasons.

First, this case, unlike the cases cited by respondents in which the Court declined review, involves the application of apparent authority, rather than respondeat superior. The tension between common law agency principles, and principles of liability under section 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t(a), is particularly exacerbated where no authorized corporate act was committed and, therefore, where there could not have been scienter by the corporation. In the absence of scienter, no legally sufficient claim for relief could be stated.

Respondents argue that the agent's scienter should be imputed to the principal, for there was "apparent authority." But this begs the question. AZL does not dispute that corporations act only through their agents. Nor does AZL dispute that where an agent acts for the corporation, his scienter is imputed to the corporation. But, where, as here, the agent acts for himself, with no intent to further a corporate purpose, there is no logical basis for imputing the agent's scienter to the corporation. It may be that under the common law a principal is liable for the fraud of his agent committed with apparent authority. This does not mean, however, that statutory liability under section 10b-5 may be found against the corporation absent a showing that there was a corporate intent to defraud, or that the corporation benefitted from the fraud. This is the teaching of *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), and the meaning of section 20(a).

Second, in the five years since the Court last declined to consider the effect of section 20(a) on common law agency principles, the lower courts have shown a confusion that has made them unable to apply a coherent theory of vicarious liability under the securities laws. Compare, for example, the district court opinions in *Frankel* v. *Wyllie & Thornhill, Inc.*, 537 F. Supp. 730 (W.D. Va. 1981) (common law principles applicable in Fourth Circuit) with *Haynes* v. *Anderson & Strudwick, Inc.*, 508 F. Supp. 1303 (E.D. Va. 1982) (common law principles not applicable in Fourth Circuit).[1]

1. Even where a consistent result is reached, the theoretical underpinnings of such liability become confused. Thus, the district court in this case apparently believed that it was holding AZL "directly" liable for the acts of its agent, as opposed to vicariously liable. App. D at 38a. The First Circuit made no such distinction, finding apparent authority to be another type of vicarious liability. App. A at 8a.

Third, since common law agency issues were last presented to this Court, this Court decided *American Society of Mechanical Engineers* v. *Hydrolevel Corp.*, 456 U.S. 556 (1982), applying principles of apparent authority to the Sherman Act. The First Circuit applied *Hydrolevel* to the securities laws, without taking into account section 20(a) and the teachings of *Ernst & Ernst* v. *Hochfelder*, 425 U.S. at 200, that Congress in the securities laws, as distinguished from the antitrust laws, fashioned standards of fault on a particularized basis.

We submit that the Court should now decide the issue of the applicability of common law apparent authority principles to the securities laws and provide guidance for the lower courts. The issue was important in the antitrust context. It is equally important in the securities context.

Respectfully submitted,

ALVIN K. HELLERSTEIN
(Counsel of Record)
THOMAS FARBER
STROOCK & STROOCK & LAVAN
7 Hanover Square
New York, New York 10004
(212) 806-5400

and

JEROME GOTKIN
GORDON P. KATZ
WIDETT, SLATER & GOLDMAN, P.C.
60 State Street
Boston, Massachusetts 02109
(617) 227-7200

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No. 85-1877

In the Supreme Court of the United States

OCTOBER TERM, 1986

AZL RESOURCES, INC., PETITIONER

v.

MARGARET HALL FOUNDATION, INC., ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

DAVID A. SIRIGNANO
Assistant General Counsel

ANNE H. SULLIVAN
Attorney
Securities and Exchange Commission
Washington, D.C. 20549

19pp

QUESTION PRESENTED

Whether the alleged liability of petitioner, a corporation, for securities fraud in the circumstances of this case is primary or secondary liability and, if it is secondary, whether Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78t(a), precludes the application of common law vicarious liability principles to impose secondary liability on a corporation.

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In the Supreme Court of the United States

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No. 85-1877

AZL RESOURCES, INC., PETITIONER

v.

MARGARET HALL FOUNDATION, INC., ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

1. This case involves an alleged scheme to manipulate the price of the common stock of AZL Resources, Inc. (AZL), a company engaged in oil and gas exploration whose stock is listed on the American

and Pacific Stock Exchanges. The complaint,[1] whose allegations have not yet been tested at trial, asserted that senior AZL officials induced Atlantic Financial Management, Inc. (Atlantic), a registered investment adviser, to purchase AZL stock for respondents by making false and misleading statements about AZL's merger and acquisition prospects.

In particular, the complaint alleged that, beginning in April 1981, Maurice Strong, AZL's chairman, made repeated statements, both privately to Atlantic and publicly to other investment advisers and institutional investors, to the effect that AZL was actively exploring merger and acquisition possibilities (Complaint ¶¶ 30-61). The complaint further alleged that AZL issued a press release on November 6, 1981, representing that it was "actively pursuing acquisition and/or merger opportunities which would add significantly to the Company's income and prospects in the petroleum business" (Complaint ¶ 44). It also alleged that Strong made fraudulent public statements about the discovery of oil near property in which AZL had an interest (Complaint ¶ 35), as well as other fraudulent private statements (Complaint ¶ 40).

The complaint alleged that these optimistic statements about AZL's prospects induced Atlantic to purchase a substantial quantity of AZL stock for respondents in 1981 and early 1982 (Complaint ¶¶ 36, 39, 50, 51, 60). During that same period, however, several of AZL's officers and directors, as well as a 10% corporate shareholder controlled by Strong, are

[1] Six different damage actions were consolidated for the purpose of ruling on the defendants' motions to dismiss. All the complaints are substantially the same and will be referred to as "the complaint."

alleged to have sold more than 154,000 shares of AZL's outstanding securities at prices ranging from $23 to almost $29 a share (Complaint ¶ 42). In January 1982, the price of AZL's shares began to drop sharply, falling to $17.87 by February 8, 1982 (Complaint ¶¶ 55, 58). On February 9, 1982, AZL issued a second press release, which stated that "recent information * * * has caused AZL to reevaluate its position regarding potential mergers or acquisitions" (Complaint ¶ 57). By July 7, 1982, AZL stock was trading at $4.62 a share (Complaint ¶ 60).

2. The complaint as originally filed alleged that Strong, AZL, and other defendants had violated Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.[2] AZL moved to dismiss on the ground that it could not be liable for Strong's conduct because that conduct did not benefit AZL. AZL also asserted, in the alternative, that Section 20(a) of the Exchange Act, 15 U.S.C. 78t(a), which provides that a person who "controls" any person liable under the Exchange Act is liable jointly and severally with the controlled person "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation," provides the sole basis for secondary liability under the Exchange Act. Respondents answered, inter alia, that the corporate liability here is primary, not secondary. See C.A. App. 169-170.

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[2] The complaint also alleged (Complaint ¶¶ 62-72) that Strong and other defendants were secondarily liable for AZL's violations as "controlling persons" of AZL under Section 20(a) of the Exchange Act, 15 U.S.C. 78t(a). The complaint did not allege that AZL was a controlling person of any liable person or entity.

The district court dismissed the claim against AZL. The court asserted that "for a corporation to be held liable as a principal for the fraud of one of its officers, a party must show both that the fraud occurred in the course of the officer's employment and for the benefit of the corporation" (Pet. App. 23a). Here, the court concluded, the alleged fraudulent conduct could not have benefited AZL, so "[t]he only possible view of the facts as alleged is that the individual defendants were pursuing their own selfish ends" (*ibid.*).

Respondents then sought to amend the complaint to assert both that AZL could have benefited from Strong's activities (see C.A. App. 174-191) and that Strong acted with " 'at least apparently authority' " in conducting the fraudulent scheme (Pet. App. 30a). The court again rejected the first of these theories (*ibid.*). But it granted leave to amend the complaint to assert the apparent authority theory of liability, stating that, "[u]nder general agency principles, a corporation is liable for the fraud of its agent committed with apparent authority even if the agent's conduct was effected for his benefit alone" (*ibid.*). The court added (*id.* at 31a) that

> AZL's liability for Strong's fraud would be established by proof that Strong appeared to be acting within the scope of his authority when he disseminated allegedly false or material [*sic*] information, and that AZL had put him in a position to commit this fraud upon [respondents]. At this stage, the allegations that Strong was AZL's chairman, a position customarily allowing the officeholder to speak for and negotiate on behalf of the corporation, and that ostensibly he was pursuing the corporate goal of raising

capital, sufficiently support the assertion that Strong acted with apparent authority.

The district court subsequently denied AZL's motion for reconsideration, explaining that respondents' "allegation of Strong's apparent authority [is] legally sufficient [to establish liability] on the basis of a corporate principal's direct liability for the binding acts of its agents, not *respondeat superior*" (Pet. App. 38a). But the court did certify its order as appropriate for interlocutory appeal pursuant to 28 U.S.C. 1292(b) (Pet. App. 39a).

3. On appeal, AZL contended that apparent authority principles may only support secondary liability, and renewed its contention that a corporation may be held secondarily liable for a corporate officer's violation of the Exchange Act only under Section 20(a), 15 U.S.C. 78t(a). AZL therefore maintained that it could escape liability by demonstrating that it acted in good faith and did not induce Strong's fraudulent conduct (see AZL C.A. Br. 12-19). While AZL recognized that Section 20(a) does not come into play when the corporation's liability is primary, AZL contended that the corporation's liability is primary only when the fraud is committed for its benefit (AZL C.A. Reply Br. 3). Respondents replied that a corporation is primarily, rather than vicariously, liable for frauds committed by its agents acting within the scope of their apparent authority (C.A. Br. 8-12); respondents also contended that, even if AZL were viewed as being only secondarily liable here, Section 20(a) does not provide the exclusive vehicle for imposing vicarious liability under the Exchange Act.

Although it ruled for respondents, the court of appeals did not address their threshold contention that

AZL should be viewed as primarily, rather than secondarily, liable for Strong's alleged fraud. Instead, the court posed the issue before it as whether "the existence of [Section 20(a)] foreclose[s] holding a principal (say, a corporation) or an employer (who 'controls' an agent or employee) 'vicariously liable' when the proviso's two conditions [that the controlling person acted in good faith and did not directly or indirectly induce the violation] are not met" (Pet. App. 4a). The court answered this question by holding that "section 20(a) does not constitute an exclusive substitute for vicarious liability that might otherwise exist" (*ibid.*), "at least in respect to the common law 'apparent authority' theory here at issue" (*id.* at 5a). Looking to the legislative history and background of Section 20(a), the court of appeals concluded that the provision was not intended to displace common law liability (Pet. App. 9a-15a).

DISCUSSION

As posed by AZL, the question in this case is whether Section 20(a), which makes a "controlling person" liable for the violations of a controlled person but gives the controlling person a good faith defense, precludes the application of common law vicarious liability principles to hold a corporation liable for its agent's violations of the Exchange Act. That question is a significant one, and one on which the circuits are divided. In our view, however, that question is not squarely presented in this case. To the contrary, respondents' complaint alleges, and makes out a colorable claim, that AZL is directly or primarily, rather than vicariously or secondarily, liable for the fraud at issue here. In these circumstances, review of the interlocutory decision below—

which, like the petition, fails to address the possibility of primary liability in this case—may not provide this Court with an opportunity to decide whether Section 20(a) displaces common law principles of vicarious liability.

1. The United States has previously urged the Court to decide whether Section 20(a) provides the exclusive remedy against controlling persons and precludes holding a corporation vicariously liable on common law theories for its agent's violations of the Exchange Act. 80-2211 U.S. Br., *Smith Barney, Harris, Upham & Co.* v. *Henricksen.* The circuits are divided on this question, which arises with considerable frequency. The majority view—adopted by the Second, Fifth, Sixth, Seventh, Eighth, Tenth, and now the First Circuits—is that common law agency principles apply in cases brought against corporations and other employers under the securities laws.[3] The Ninth Circuit, on the other hand, has held that agency principles are inapplicable in such cases, so that the liability of employers for the fraudulent acts of their employees must be determined exclusively by application of the controlling-person provisions contained in Section 20(a) of the Exchange Act and in the parallel Section 15 of the Securities

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[3] See, *e.g.*, *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011 (1980); *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801, 812-813 (2d Cir. 1975); *Paul F. Newton & Co.* v. *Texas Commerce Bank*, 630 F.2d 1111 (5th Cir. 1980); *Holloway* v. *Howerdd*, 536 F.2d 690, 694-695 (6th Cir. 1976); *Armstrong, Jones & Co.* v. *SEC*, 421 F.2d 359, 362 (6th Cir.), cert. denied, 398 U.S. 958 (1970); *Henricksen* v. *Henricksen*, 640 F.2d 880 (7th Cir.), cert. denied, 454 U.S. 1097 (1981); *Fey* v. *Walston & Co.*, 493 F.2d 1036, 1052 (7th Cir. 1974); *Commerford* v. *Olson*, 794 F.2d 1319 (8th Cir. 1986); *Kerbs* v. *Fall River Industries*,

Act, 15 U.S.C. 77o.[4] The Third Circuit has also held that as a general matter the liability of a principal under the securities laws may not be grounded on respondeat superior, although it has recognized an exception to this rule in cases involving accounting and broker-dealer firms.[5]

2. The question whether Section 20(a) precludes other theories of secondary liability arises, however, only when the plaintiff seeks to impose liability on the corporate principal vicariously, for the acts of its agents, rather than directly for its own acts. Congress plainly intended corporations to be directly and primarily liable under the securities laws for violative conduct that constitutes an act of the corporation itself. In particular, a corporation can plainly be held directly liable for *its* misstatements: Section 10(b) of the Exchange Act makes it unlawful for any "person" to engage in fraudulent conduct, and the term "person" is in turn defined in Section 3(a)(9), 15 U.S.C. 78c(a)(9), to include a "com-

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Inc., 502 F.2d 731, 741 (10th Cir. 1974). The Fourth Circuit appears to have adopted this approach as well. See *Johns Hopkins University* v. *Hutton*, 422 F.2d 1124, 1130 (1970), cert. denied, 416 U.S. 916 (1974); *Carras* v. *Burns*, 516 F.2d 251, 259, 261 (1975). But see *Carpenter* v. *Harris, Upham & Co.*, 594 F.2d 388 (4th Cir.), cert. denied, 444 U.S. 868 (1979). Compare *Frankel* v. *Wyllie & Thornhill, Inc.*, 537 F. Supp. 730 (W.D. Va. 1982), with *Haynes* v. *Anderson & Strudwick, Inc.*, 508 F. Supp. 1303 (E.D. Va. 1981).

[4] See *Zweig* v. *Hearst Corp.*, 521 F.2d 1129 (9th Cir.), cert. denied, 423 U.S. 1025 (1975); *Kamen & Co.* v. *Paul H. Aschkar & Co.*, 382 F.2d 689, 696-697 (9th Cir. 1967), cert. dismissed, 393 U.S. 801 (1968).

[5] See *Sharp* v. *Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982); *Rochez Bros.* v. *Rhoades*, 527 F.2d 880 (3d Cir. 1975).

pany." Other provisions, including Sections 13(a), 15 and 17, 15 U.S.C. (& Supp. III) 78m(a), 78o and 78q, impose obligations upon "issuers," "brokers" and "dealers," which often are corporate entities.[6] Indeed, AZL recognizes that corporations may be deemed *directly* liable under the securities laws for certain acts of their employees that were not expressly authorized or ratified by the shareholders.[7]

Several courts, including this Court[8]—and includ-

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[6] The legislative history of the Exchange Act demonstrates that it was designed in large part to curb abuses committed by corporations and other entities. See S. Rep. 792, 73d Cong., 2d Sess. 10 (1934) (corporate reports); *id.* at 12 (proxy statements); *id.* at 11-12 (brokerage firms); S. Rep. 1455, 73d Cong., 2d Sess. 68-74 (1934) (corporate reports); *id.* at 74-77 (proxy statements); *id.* at 163-221 (investment banking); *id.* at 333-384 (holding companies). The Securities Act of 1933, 15 U.S.C. (& Supp. III) 77a, requires a registration statement to be signed by the issuer (§ 6, 15 U.S.C. 77f), and makes each signer liable for any material misstatement of fact therein (§ 11, 15 U.S.C. 77k). It was a central purpose of both the Securities Act and the Exchange Act to impose disclosure obligations (and liabilities) directly on the issuer of the securities. See Cohen, *"Truth in Securities" Revisited*, 79 Harv. L. Rev. 1340, 1346, 1361 (1966).

[7] Before the court of appeals, AZL argued that a corporation is directly liable under Section 10(b) for the acts of its employees when those acts are committed for the corporation's benefit. See AZL C.A. Reply Br. 5.

[8] See, *e.g.*, *Herman & MacLean* v. *Huddleston*, 459 U.S. 375 (1982) (accounting firm's certification of balance sheet in case involving Section 10(b)); *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (false proxy materials in case under Section 14(a), 15 U.S.C. 78n(a)); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), after remand, 446 F.2d 1301, 1304-1306 (2d Cir.), cert. denied, 404 U.S. 1005 (1971) (misleading press release in Section 10(b) case).

ing the Ninth Circuit,[9] which has rejected "vicarious" corporate liability under the securities laws—have held corporations liable under Section 10(b) and other provisions of the securities laws, in cases where false statements or documents were issued in the corporation's name, without any suggestion that the liability of the corporation was merely derivative of the liability of another person. And the Third Circuit, which also has generally rejected Section 10(b) "vicarious" liability, has held that corporations may be "primarily" liable when the misconduct is that of a senior officer: "[H]igh ranking officers in a corporation, or partners in a partnership, present a different situation from lower level employees. Officers are able to make policy and generally carry authority to bind the corporation. Their action on behalf of the corporation is therefore primary, and holding a corporation liable for their actions does not require respondeat superior." *Sharp* v. *Coopers & Lybrand*, 649 F.2d 175, 182 n.8 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982). See also *Holmes* v. *Bateson*, 583 F.2d 542, 561 (1st Cir. 1978).[10]

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[9] See *SEC* v. *Goldfield Deep Mines Co.*, 758 F.2d 459 (9th Cir. 1985) (false registration statement in case involving 15 U.S.C. 78*l*(g)); *SEC* v. *Blazon Corp.*, 609 F.2d 960 (9th Cir. 1979) (false offering circular in case involving Section 17(a) of the Securities Act); *Marx* v. *Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974) (inflated earnings projection in case involving Section 10(b) of the Exchange Act).

[10] This conclusion draws some support from the treatment of corporate directors under the common law. Directors "are not agents since they are the controllers rather than the controlled * * *. Their position makes them sui generis in the hierarchy of legal conceptions." W. Seavey, *Handbook of the Law of Agency* § 10, at 18-19 (West 1964). See also Restatement (Second) of Agency § 14C (1958). Because

To be sure, corporate conduct invariably involves one or more human actors. But a false statement can be the act of a corporation (although a human actor is required), just as a promissory note can be the act of a corporation, and in either case the liability thereon is direct and not derivative, so there is no need to rely on *either* common law vicarious liability principles *or* a statute imputing liability, as Section 20(a) imputes liability to controlling persons. There may, of course, be a question whether a given action *is* the act of the corporation, but where the answer to that question is yes, there is no occasion to determine which theories of vicarious liability may be valid and available.

In the present case respondents have made a colorable claim of primary liability on the part of AZL, as the district court recognized (see Pet. App. 38a). AZL issued a misleading press release in its own name. Compare *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 845, 861 (2d Cir. 1968) (en banc), after remand, 446 F.2d 1301, 1304-1306 (2d Cir.), cert. denied, 404 U.S. 1005 (1971). The fraud here, moreover, was conducted largely by AZL's chairman, who issued public statements and dealt with investors on AZL's behalf. And respondents asserted below that the fraud was committed for AZL's benefit;[11] while the district court rejected that contention (see Pet. App. 23a, 30a), it did not consider whether such a benefit is necessary to create primary liability. Respondents' argument also has not been

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such officials control the corporation, it is entirely fictitious to view their actions as anything other than the actions of the corporation.

[11] Respondents repeat that assertion before this Court. See Br. in Opp. 4 n.2.

addressed by the court of appeals, which evidently viewed the issue as outside the question certified for interlocutory appeal.

In these circumstances, review of the decision below is not justified. Because AZL's liability here may be primary, resolution of the question presented in the petition—whether Section 20(a) precludes common law vicarious liability under the Exchange Act—may be irrelevant to the outcome of this case. Indeed, before reaching the question presented, the Court would have to decide whether the liability alleged is primary or secondary, an issue that is not addressed by the petition, was not discussed by the court of appeals here, and has not yet been analyzed in depth by other courts of appeals. Its consideration by this Court in this case accordingly would be premature.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FRIED
Solicitor General

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

DAVID A. SIRIGNANO
Assistant General Counsel

ANNE H. SULLIVAN
Attorney
Securities and Exchange Commission

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PETITIONER'S SUPPLEMENTAL BRIEF IN RESPONSE TO BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

ALVIN K. HELLERSTEIN
(Counsel of Record)
ALAN M. KLINGER
STROOCK & STROOCK & LAVAN
7 Hanover Square
New York, New York 10004
(212) 806-5400

and

JEROME GOTKIN
GORDON P. KATZ
WIDETT, SLATER & GOLDMAN, P.C.
60 State Street
Boston, Massachusetts 02190
(617) 227-7200

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the First Circuit

PETITIONER'S SUPPLEMENTAL BRIEF IN RESPONSE TO BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

The Solicitor General's Brief acknowledges that the issue presented for certiorari—whether Section 20(a) precludes common law "vicarious" liability under the Securities Exchange Act—"is a significant one, and one on which the circuits are divided" (Br. for U.S. 6). Indeed, the Solicitor General previously urged the Court to decide this question (*Id.* 7).[1] However, based on the erroneous belief

1. The question is particularly pertinent today in light of the number of lawsuits that have recently been filed involving the "insider trading" scandals, many of which raise the issue of a brokerage firm's "vicarious" liability for the misdeeds of its officers and employees.

that there is still a colorable claim of "primary" liability in this case, the Amicus Brief, signed by five attorneys of the Securities and Exchange Commission and the Solicitor General, advises against granting certiorari. But there is no colorable claim of "primary" liability in this case, as we again show below. And even if there were, it should not result in the denial of certiorari, for the issue presented in the Petition is still an issue in the case, and an important and unresolved one, as everyone acknowledges.

The lower court decisions plainly demonstrate that respondents' theory of "vicarious" liability is the only theory of liability remaining in this case; that the district court eliminated any other theory of liability; that the theory of liability remaining in this case is based on a claim of apparent authority; and that such claim is entirely inconsistent with any liability notion other than one of "vicarious" liability, for one cannot be "primarily" liable for an act which he did not authorize.

Respondents' "primary" liability claim against petitioner AZL Resources, Inc. ("AZL") was twice rejected by the district court. Only one theory of liability against AZL survived AZL's motions to dismiss, and that is a theory of "secondary" or "vicarious" liability based on common law concepts of "apparent authority" (Pet. App. 30a). This is also the only theory of liability that was considered by the court of appeals, pursuant to the district court's certification under 28 U.S.C. Sec. 1292(b) (Pet. App. 39a).

In response to AZL's first motion to dismiss, the district court rejected respondents' self-described "primary" liability theory (Br. for U.S. 3) because the very facts alleged

by respondents in their complaint "negate[d] any inference that the actions of Strong [AZL's chairman] were performed for the benefit of AZL" (Pet. App. 23a). Respondents then sought to amend their complaint to assert that AZL *could have* benefited from Strong's activities (a "primary" liability theory) and, also, that Strong acted with "at least apparent authority" in conducting his fraudulent scheme (a "secondary" liability theory) (Pet. App. 30a). The district court again dismissed respondents' "primary" liability theory, finding respondents' theory of benefit to AZL implausible (Pet. App. 30a). But it granted respondents leave to amend their complaint to assert a "secondary" liability theory against AZL, based on Strong's "apparent authority" (Pet. App. 31a).

AZL thereupon moved for reconsideration. The district court denied AZL's motion for reconsideration, but in its opinion it specifically noted that "[t]he amendment [to the complaint] made AZL a defendant once again in this litigation" *solely* "on the basis of an allegation that AZL's chairman, Maurice Strong, acted with the apparent authority of the corporation in committing securities fraud" (Pet. App. 37a). It is in that connection, assuming it is eventually proved that Strong *did* act with apparent authority, that the district court stated that AZL's liability would be direct, that is, as a principal, and not because of *respondeat superior* (Pet. App. 38a), a distinction in theories which was the subject of extended discussion by the circuit court but which is not germane to the issue on this Petition.

At no time in any of its three opinions did the district court state or imply that respondents had alleged a legally

sufficient claim of "primary" liability against AZL.[2] Indeed, the district court specifically rejected any such notion. Thus, the district court, in granting AZL's request for certification under 28 U.S.C. Sec. 1292(b), ruled that the question of law being certified was "controlling," and that a reversal of its ruling *"will terminate the litigation as to AZL"* (Pet. App. 39a). If the district court believed that a colorable claim of "primary" liability against AZL were still present, a reversal of its ruling on the viability of respondents' "apparent authority" theory of liability *would not have terminated the litigation as to AZL.*

If the Solicitor General's reading of the district court's decisions were correct, the district court engaged in a futile gesture in certifying the question at issue to the court of appeals, and the court of appeals engaged in a futile gesture in granting AZL's petition for leave to appeal and then determining the matter without reference to respondents' contention that a colorable claim of "primary" liability against AZL was still present in this case (Br. for U.S. 5). We respectfully submit that neither court engaged in such a futile gesture. Rather, both courts decided the only issue they believed remained in the case—to wit, whether respondents' claim of "secondary" liability as to AZL was viable under the Exchange Act.

Finally, even if the Solicitor General were correct that a "primary" liability theory remains, we do not believe

2. The Solicitor General believes that the district court did so in its denial of AZL's motion for reconsideration, by referring to a certain allegedly "misleading press release" of AZL (Br. for U.S. 11). That reference, however, can only be understood in the context of the district court's consideration of the legal sufficiency of the complaint's allegations of Strong's "apparent authority" (Pet. App. 30a). The district court considered that the press release was an unauthorized press release which Strong had the "apparent authority" to issue, and that Strong's representations were manipulative and not a disclosure of "inside information."

that warrants a denial of AZL's Petition. Resolution of the unresolved issue of whether the statutory "controlling person" defense of good faith precludes application of common law liability principles in securities cases would, if favorable to AZL, eliminate the major part of the claims against AZL and would also, regardless of the outcome, erase many years of confusion and conflict in the law.

In conclusion, the "significant" question "on which the circuits are divided" *is* "squarely presented in this case," and the "resolution of the question," if in favor of AZL, will, as the district court explicitly found, "terminate the litigation as to AZL" or, if the Solicitor General is correct, terminate at the very least a significant part of it.

The Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

ALVIN K. HELLERSTEIN
(Counsel of Record)
ALAN M. KLINGER
STROOCK & STROOCK & LAVAN
7 Hanover Square
New York, New York 10004
(212) 806-5400

and

JEROME GOTKIN
GORDON P. KATZ
WIDETT, SLATER & GOLDMAN, P.C.
60 State Street
Boston, Massachusetts 02190
(617) 227-7200

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